HG 1025 .I2 1988

International Macroeconomic Policy Coordination

Group of Thirty

New York & London

The study group on International Macroeconomic Policy Coordination was set up by the Group of Thirty as a contribution to its general work on international economic and monetary issues. Publication of this Report does not imply endorsement by the Group of Thirty of any of the views expressed.

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Published by
Group of Thirty©
New York and London
1988

Preface

In December 1987 a Study Group was established under the auspices of the Group of Thirty to examine, and propose improvements to, the process of international macroeconomic policy coordination. It was felt that the time was ripe to look back at the post-war record of policy coordination and to see what lessons could be drawn from it for the future. The Study Group, whose membership is set out below, comprised academics and practitioners who were readily available for meetings in London, but comments on an earlier draft were received from a wider circle.

Inevitably the report touches on a wide range of controversial issues in economic policy making and individual members of the Study Group, who served in a personal capacity, do not necessarily wish to be identified with all the views expressed. They are however all associated with the general message of the report and with its conclusions.

The report is divided into four main sections. We begin by considering the essential rationale for policy coordination and establishing some key definitions. In the second section we review the post-war history of policy coordination, from the Bretton Woods era to the present post-Louvre period. As a result of this review, we consider in the third section how the process of policy coordination might be improved in the longer-term—in particular we favour a more systematic approach to policy coordination with the major economies making a greater commitment to exchange rate stability. Finally, we suggest a possible way forward in the meantime.

The members of the Study Group hope that their report will contribute usefully to debate about the future of international policy

coordination. They would like to conclude by putting on record their deep gratitude to their secretary, Mr Richard Brown, who not only drafted their report but contributed significantly to their thinking.

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September 1988

1. Policy Coordination: Rationale and Forms

Before introducing some of the terms and concepts we will be using later we begin by considering briefly the fundamental issue, namely the essential *rationale* for policy coordination. This stems from the strong and growing interdependence of economies, with the consequence that economic developments and policies abroad can have a significant impact on the domestic economy and vice versa. At times these overseas influences can be helpful—for example, the fall in US interest rates after mid-1982 facilitated declines in interest rates in other major economies. At other times they can be distinctly unhelpful, as when the massive over-valuation of the dollar during 1982–85 hindered the anti-inflation struggle elsewhere. The challenge for policy coordination, then, is to explore whether economic policies in different countries can be mutually adjusted so as to strengthen the more helpful interactions and reduce the adverse influences.

Some have argued, however, that policy coordination beyond an exchange of information is either not necessary or can even be harmful, for example if it were to encourage the pursuit of inappropriate domestic policies. This contrary case tends to be associated with support for unmanaged exchange rates. With these, it is argued, a country has an incentive to avoid economic policy errors—excessively tight policies, for example, will tend to result in exchange rate appreciation and loss of competitiveness in the country following such policies, while exchange rate depreciation will amplify the inflationary effects of lax policies. Thus any policy

mistakes which are made will be contained mainly within that economy; should there be a potential problem for other countries they have sufficient policy instruments at their disposal to offset any adverse effects.

The option of not coordinating policies internationally can at times appear tempting, and we examine it in more detail in Section 3. For the moment we will note the essential case against the floating exchange rate regime. This is that it tolerates very substantial misalignments of key exchange rates, for example, the serious overvaluation of the US dollar. These misalignments, which arise both from speculative market pressures and from policy divergences, have had very great costs, including the growth of protectionist pressures and the reduction in activity in industries rendered uncompetitive by overvalued exchange rates. While these costs were eventually recognised by the US and the overvaluation of the dollar was subsequently reversed, lasting damage was done in the meantime, to trade and investment in particular. Furthermore other countries were not able to offset all the harmful effects on their economies. As a consequence there is now considerable interest in avoiding such gross misalignments in the future, and this in turn suggests a prima facie case for policy coordination. This is not necessarily the same as arguing for fixed exchange rates, a point elaborated on later.

There is, however, an additional argument which relates to the desirability of avoiding collective or global errors of economic management, for example excessive inflation or overly tight policies worldwide. By their very nature, such errors will not manifest themselves in the structure of exchange rates, or at least not to any significant extent; equally, however, any country going against the trend could well be brought back into line through exchange rate pressures. This suggests a case for, at the minimum, a careful consideration of the overall stance of policies in the leading industrial countries. Such a consideration has to take place in a multilateral context, preferably with agreed procedures about how any necessary policy changes can be introduced. We term this *absolute* coordination to distinguish it from the *relative* coordination which focuses on exchange rate relationships and balance of payments interactions.

International economic policy coordination can be said to take place whenever countries modify their economic policies in what is

intended to be a mutually beneficial manner, taking account of international economic linkages; and this is the definition we use throughout the report. Under this, admittedly broad, definition the process of policy coordination can take a variety of *forms*, ranging from the discussion of economic developments and forecasts to full blown "package deals" where countries undertake to implement a mutually agreed set of policy changes. The latter is the most clearcut and publicised manifestation of policy coordination, although in practice it is comparatively rare—a well known example is the Bonn economic summit deal of 1978. At the other end of the scale are the exchanges of information and forecasts which take place in numerous international fora, and also the bilateral exchanges between countries. An example here is the multilateral surveillance process recently established by the Group of Seven industrial countries. In between we have a wide spectrum of economic collaboration, in which countries may adjust their policies but without making mutually binding commitments.

Three other important distinctions can be made. The first is between coordination aimed at establishing, preserving or changing, or adjusting to a system of *rules*, and coordination aimed at making policy changes in a *discretionary* manner. Both "rules" and "discretionary" are inevitably shorthand phrases. The former is not necessarily rigid and the latter is not necessarily crisis-driven. A good example of the former type of coordination is the exchange rate and international liquidity arrangements of the Bretton Woods system, and, indeed, the multilateral trade system itself. Here the emphasis is very much on establishing a rulebook with individual countries free to follow their own policies within the agreed framework. Macroeconomic policy changes agreed between countries within a given international economic system would fall in the second type—the Bonn summit deal noted above is an example of this. As we shall see, these two types can be alternative ways of achieving policy coordination—a greater concentration on adhering to sets of rules may reduce the need for more discretionary policy coordination, and vice versa.

A further distinction can be made between *explicit* and *tacit* policy coordination. Explicit coordination takes place when countries make specific agreements to change their policies, or indeed to

change the rules governing the international economic system. Tacit coordination, on the other hand, occurs when countries respond to external economic developments without any prior agreement—for example if a country changed its fiscal or exchange rate policy to forestall either international criticism or action against its exports.

Finally, we can distinguish between *global* and *regional* coordination. There are many examples of regional economic coordination, eg the economic arrangements of the European Economic Community including the European Monetary System, and the plans for a single European market. However this Study Group has concentrated on global policy coordination, *ie*, coordination on a global basis between major countries, either singly or in regional economic groupings.

Having noted briefly the various forms of coordination we now turn to its *focus*. The immediate and natural focus is on economic interactions between economies. These include both balance of payments flows on current and capital account, and key prices such as exchange rates and interest rates. Thus in the first instance Germany's concern with French economic policies, for example, lies in their point of impact on the German economy, mainly in their effects on German export markets, interest rates, and the exchange rate. This naturally leads to consideration of the economic developments and policies which have a significant impact on these external variables. Given the highly interdependent nature of modern economies, however, the possible list of developments and policies is wide ranging. It clearly includes the traditional macroeconomic policy instruments, fiscal and monetary policy for example, but it may also involve a range of microeconomic and structural policies.

Next we consider the *objectives* of policy coordination. Within an economy the objectives of economic policy usually include the achievement of as high a rate of sustainable growth and as low a trend rate of inflation as possible over the medium-term, subject to a number of constraints, including the avoidance of balance of payments pressures. Thus the objective of policy coordination can be defined as the mutual easing of the constraints on national economic goals caused by economic developments and policies in other countries. Related to this is the avoidance of unsustainable

developments in external economic variables, the eventual resolution of which can cause severe economic disruption.

In some cases policy coordination may lead to an unambiguous improvement in one or several dimensions of each country's economic performance without any offsetting deterioration in any other dimension. An example of this would be the simultaneous expansion of demand in countries suffering from deficient demand, and where demand expansion in any one country would be constrained by the potential emergence of balance of payments problems or by inflation induced by a fall in the exchange rate. Another example would be an agreement to eschew expansionary demand management policies so as to reduce the risk of precipitating a commodity price boom; for instance there might have been generalised welfare gains if such a course of action had been followed in 1972–73.

In most cases, however, coordination will lead to an improvement in some dimensions of economic performance and a deterioration in others, and the mix will be different for different countries. Output growth may be higher in one country and inflation lower; the two will be reversed in another country. Nevertheless, each participating country can expect to gain on balance; it would face a better trade-off among its various policy targets. It is usually not sufficient to be able to argue that an agreement will benefit the group as a whole; negotiators have to be able to argue that the outcome envisaged will be beneficial to their own country. Commonly that argument has to be made in political as well as economic terms. This helps explain a major difficulty in achieving policy coordination—politicians rarely see any advantage in changing policies at the behest of other countries. They therefore have to be persuaded and convinced that such changes will be to their own advantage and that other countries will fulfil their sides of the bargain.

2. Policy Coordination in the Post-War Period

In this section we review the post-war history of policy coordination using some of the distinctions introduced earlier. Although any divisions can be contentious, we have found it useful to distinguish five sub-periods:

—the Bretton Woods era of fixed but adjustable exchange rates;

—1971–75, with several attempts to reinstate fixed parities;

—1975–78, an active period for policy coordination;

—1979–85, the phase of the monetarist response to inflation;

—1985 to date, a period of renewed interest in policy coordination.

2.1 The Bretton Woods era

Although it was not viewed in these terms at the time, this era can now be regarded as one of significant policy coordination. However, as noted earlier, this was achieved not so much by *ad hoc* policy coordination but rather through countries adhering to a set of mutually agreed rules, adjusting their policies in response to the discipline imposed by the rules, and accepting the right of international institutions to comment on and criticise their policies. These rules included the commitment to a system of fixed but adjustable exchange rates, and related international liquidity arrangements with the US undertaking to convert surplus dollars into gold at the official parity of $35 per ounce.

These rules governing monetary cooperation were established initially at the Bretton Woods conference of 1944. Subsequently, several policy initiatives were taken designed to preserve the Bretton Woods system. These were directed at the international liquidity arrangements which proved to be inherently unstable, with the combination of modest inflation and strong growth in world trade producing a demand for liquidity which undermined the reserve asset position of the US. This triggered a series of collaborative measures aimed at augmenting international liquidity, including the establishment of the General Arrangements to Borrow (whose original members were known as the Group of Ten), the Gold Pool arrangements, and the creation of the SDR. At the other end of the spectrum, coordination, in the sense of development of statistics, exchange of analysis and discussion of forecasts, was being built up, especially in the IMF and the OECD. There were numerous examples of economic collaboration. *eg*, countries in balance of payments difficulties drew foreign exchange from the IMF in return for adopting stabilisation programmes. Arguably, however, there was no explicit macroeconomic policy coordination, at least in the sense of "package deals"—the system was dependent on good behaviour by its key player, the US, and on the external constraints faced by deficit countries.

On this view the macroeconomic coordination which took place was largely the result of the automatic discipline imposed by the system, and when it failed it did so because the discipline was not automatic (for example in the case of the United States). In particular, countries running current account deficits tended to experience reserve losses, often exacerbated by capital outflows. They therefore had an incentive to take adjustment measures which restricted or even reversed these deficits--in extreme cases these measures included devaluation. On occasion the exact nature of the measures to be taken could be the subject of intense international negotation, and the use of IMF resources was usually made conditional upon measures of adjustment; however the essential point was that the need for adjustment was enforced by the system. Surplus countries generally felt less pressure to adjust, though the build-up of reserves could cause monetary problems if complete sterilisation was not possible. The US was of course in a unique position in this system

and, especially in the second half of the 1960s, was a source of inflationary pressure to the world economy.

Retrospectively the Bretton Woods period is widely regarded as a golden age, especially for the expansion of world trade and for economic growth. Most would probably agree that the system itself was an important factor behind this success. However the era ended in crisis, resulting in large and disruptive changes in exchange rates. The division of responsibility among the possible factors responsible for the breakdown of the system is still controversial. Nevertheless a useful distinction can be made between technical weaknesses of the system itself, the failure of countries to abide by the rules, and structural changes which undermined the system. Technical weaknesses of the system included the inherent instability of the international liquidity arrangements, as noted above, and the problems deriving from the narrowness of the exchange rate bands. The inflationary policies of the US in the late 1960s, and the reluctance of the US to change the price of gold and other major countries to change their parities, reflected an unwillingness to play by the rules. The decline in US hegemony, and the growth of world capital flows which increasingly tested parities regarded as untenable, are examples of structural changes which undermined the system.

2.2 1971-1975

From a macroeconomic viewpoint the 1970s were a troubled and difficult decade. Policy makers had to deal with a new phenomenon, namely the coexistence of inflation and unemployment at higher levels than they had been for a long time. The breakdown of the Bretton Woods fixed exchange rate system and the first oil shock posed further problems. Perhaps not surprisingly, given the success of the old system in promoting growth, a recurring theme of this period was a series of attempts at reviving the Bretton Woods rulebook. In the Smithsonian agreement of December 1971 the major industrial countries announced a new set of parities which were intended to be consistent with sustainable balance of payments positions; at the same time the dollar was devalued against gold to $38 per ounce. Reflecting greater uncertainty and in an attempt to incorporate enhanced flexibility into the system, the permitted

margins around the new parities were widened. However the very forces which undid the old system prevented its return, and the Smithsonian parities soon broke down. A further devaluation of the dollar against gold, and an attempt at exchange rate stabilisation within Europe (the "snake"), also failed, ushering in the era of floating exchange rates, at least between the major currencies.

The breakdown of at least part of the previous rule-based system of policy coordination was not in general compensated for by increases in the more *ad hoc* forms of coordination. That said, it would be wrong to regard this period as one of international economic anarchy. The liberal trading system survived the temporary imposition of a 10% import surcharge by the US in mid-1971. Furthermore the IMF reacted to the sharp increases in the price of oil over 1973–74 by introducing Oil Facilities under which oil-importing countries could draw foreign exchange in return for adopting macroeconomic policies which attempted to offset partially the demand-deflationary impact of the oil price rises and protected the liberal trading system. Nevertheless the emphasis was still very much on attempts to restore a rule-based system of coordination.

In view of the current interest in the possibility of returning to some sort of rule-based system, it is worth exploring a little further why such attempts proved fruitless in the early 1970s. After all, the Bretton Woods system was held in high regard and there was no lack of either goodwill or expertise invested in attempting to rebuild it. The reasons why the enormous efforts of the Committee on Reform of the International Monetary System and Related Issues (the Committee of Twenty) came to naught in 1974 are particularly interesting. Countries were not willing to accept the significant constraints of the Bretton Woods type of system where these conflicted with the macroeconomic policies they wished to pursue; and in any case flexible rates had become both increasingly respectable, certainly in academic circles, and increasingly unavoidable, given the growth of capital flows and divergent balance of payments pressures. With respect to the problem of international liquidity, the US was unwilling to participate in schemes which would build up the role of assets such as the SDR at the expense of the dollar; in any case a structural shift from asset to liability

settlement was taking place. Other structural changes were also taking place, including a fundamental shift in the balance of power, with the growing importance of Europe and Japan, and the emergence of the ldc grouping. Finally, the significant economic shocks of the early 1970s, with their differential impact among economies, made it an unpropitious time to launch a new system.

2.3 1975–78: the lead-up to the Bonn economic summit of 1978.

By the mid-1970s there was growing acceptance that it would not be possible to return to a fixed exchange rate system in the foreseeable future. At the same time macroeconomic problems had become even more acute in most industrial countries as the repercussions of the sharp oil price rise, including the recession of 1974–75, a substantial rise in unemployment, and higher inflation, fed through. From a political viewpoint the growth in unemployment was a particularly worrying phenomenon, bringing back memories of the political and social problems of the 1930s. This was seen as providing a powerful incentive to adopt expansionary macroeconomic policies and also to remove or reduce economic constraints on such policies. The possibility that policy coordination could help in this respect triggered sustained interest in this approach, culminating in the Bonn economic summit* package of 1978.

The 1978 Bonn deal is now interpreted by some in a poor light, being blamed for exacerbating inflationary pressures in the late 1970s. Nevertheless it provides a clear example of a particular type of policy coordination and the lessons to be drawn from it are still very relevant.

In at least two important respects the economic environment of the mid 1970s was very different from that currently faced. The concerns in the West included having to adapt to the repercussions of a massive *increase* in oil prices. The need to reduce dependence on imported oil, so as to avert further oil price increases, was also a key policy consideration.

The analysis of the appropriate policy response to the rise in unemployment was also significantly different. Even though there had been for some years a growing tendency—especially perhaps in

*The participants in economic summits, and the membership of other groupings of major countries, are given in the Annex.

Germany— to question the Keynesian analysis, the basic proposition that mass unemployment indicated deficient aggregate demand and the need for expansionary policies was widely accepted. Expansionary policies were constrained to some extent by longer term fiscal considerations, but to a much greater extent by immediate inflation and balance of payments developments. If these posed no significant constraints, then fiscal expansion, sometimes on a massive scale, seemed appropriate. In the 1980–85 period there was a sharper reaction against Keynesian remedies, and the present tendency is to regard unemployment as a structural/supply side phenomenon.

The immediate origins of the summit deal stemmed from the pause in world growth in the second half of 1976 which exacerbated unemployment concerns. This reinforced the determination of some governments, in particular the US and some European countries, to adopt more expansionary fiscal policies. However these were very much constrained, both by inflation and by current account considerations. Inflation was to be kept in check in part by incomes policies as well as by avoiding further oil price rises. Reducing the external constraint was difficult—the counterpart current account surpluses were to be found not only with oil producers but also with Germany and Japan. This set the scene for protracted negotiations, especially among the G3 (the US, Germany and Japan).

In the US the Carter Administration had reacted to the demand deflationary impact of the oil price rises by cutting taxes. It was argued that this was entirely appropriate as inflation would be constrained by the existence of excess capacity and/or wage/price guidelines. While US growth was reasonably good there was concern over the deteriorating current account position and the declining dollar. This in turn led to criticism of what were regarded as unduly restrictive policies in surplus countries such as Germany and Japan. It was argued strongly that easier policies in these countries would raise growth world-wide by lifting balance of payment constraints. There was also a suspicion that the US was talking the dollar down in order to encourage both monetary and fiscal relaxation elsewhere, particularly in Germany.

The Germans could not accept, at least initially, US criticism of their policies. Partly this reflected a more optimistic view of growth prospects. It also reflected analytical differences—they were much

more inclined to view unemployment as a result of structural factors such as the growth of real wages and the decline in the share of profits, rather than as the result of an overly tight fiscal policy. Meanwhile they were in a considerable dilemma over the downward pressure on the dollar, which they saw as the inevitable outcome of inappropriate US policies. Either they intervened, leading to excessive monetary growth, or the mark appreciated further, leading to competitiveness and trade losses. The other major criticism of US policies concerned energy. Recovery in the US combined with the maintenance of energy prices well below world levels had resulted in an increase in US energy consumption in 1976/77. This was totally at variance with the objective of reducing dependence on imported oil and so weakening the power of the OPEC cartel to maintain the world price of oil. The Germans therefore put great pressure on the US to adopt a comprehensive energy plan which at the minimum would raise prices to consumers substantially.

Thus the general shape of a possible deal became clear—the US would implement an energy plan which would reduce dependence on imported oil while Germany and Japan would introduce more expansionary fiscal policies. The content of a possible package was the subject of almost continuous negotiation, both within and between governments and international organisations, after the pause in world growth in the second half of 1976. Further impetus to a deal was given by the failure of most of the participants to meet the growth targets agreed at the London summit of 1977, in particular Germany. Moreover it appears that opinion within Germany shifted to the extent that as 1978 progressed Chancellor Schmidt came to believe that reflation was desirable in Germany's own interests, though naturally he continued to oppose it in public in order to maximise his bargaining position.

In a nutshell, at the Bonn summit Germany agreed to measures which would boost its budget deficit by about 1% of GNP. Japan promised additional public spending measures if growth fell short of an ambitious 7% target. The US undertook to implement an energy package, in particular to raise domestic oil prices to world levels by end-1980. Other participants basically reaffirmed economic policy measures in the pipeline, but, most importantly,

also joined in a commitment to complete multilateral trade negotiations by the end of the year. All the measures agreed were subsequently enacted, although in some cases a considerable time after the summit.

The Bonn deal was followed by a marked deterioration in macroeconomic performance in the major economies as inflation and fiscal deficits rose significantly; furthermore the US economy entered a recession which lasted until well into 1982. It is however very difficult to separate out the effects of the second series of sharp oil price rises, and the adoption of a very tight monetary policy in the US, from those of the Bonn measures. The criticism most commonly made about the Bonn agreement is that it took place a year too late; furthermore, while few would blame the second oil shock directly on Bonn, it can be argued that the deal took insufficient account of the medium term consequences of the expansionary fiscal measures. Of course, such criticisms are easier to make with the benefit of hindsight.

In conclusion, we believe that there are lessons to be learnt from the 1978 Bonn summit deal which are still relevant to the formulation of policy coordination today. Specifically:

—In terms of its planning, construction and execution the Bonn summit should be regarded as a success. With respect to its *planning*, intensive groundwork established common interests, clarified issues and prepared the outlines of a deal. With respect to its *construction*, the final deal was wide-ranging, involving macroeconomic issues, energy policy and trade negotiations, which created sufficient trade-offs for a deal to be possible. In addition, the policy changes announced at the summit were clearly specified and publicly announced. As for *execution*, all the policy changes were enacted as agreed, in some cases after a considerable time—there was no attempt to renege on the agreement.

—The package was also successful in the sense that it facilitated the achievement of the various economic *objectives* of the participants. It did this primarily by reducing the external constraints which countries believed themselves to be under.

—With respect to *analytical* differences it is difficult to agree with the conventional view that Germany was "bounced" into reflation by US pressure. It does seem that at the time of the deal German opinion was also in favour of a reflation package. As for the US energy package, the summit deal can be viewed as bringing international pressure to bear on a US policy objective, the means of achieving which were subject to considerable domestic political conflict.

—However, it can be argued that the reflationary measures agreed at the summit did not pay sufficient attention to the rate of growth of the world economy that was already in train in 1978 (over 4% in the first half of 1978) or to the medium term consequences of fiscal expansion, which were exacerbated by the second oil shock. To an important extent such failings are inherent in the episodic approach to policy coordination which by its very nature takes a long time to come to fruition.

2.4 1979–1985

The resurgence of inflation in the major economies at the end of the 1970s, coupled with a general shift to the right of the political spectrum and the perception that the policies of the 1970s had failed, led to a widespread shift in the stance of macroeconomic policy. The central elements of the different strategy were the control, and eventual elimination, of inflation, to be achieved through progressive lowering of monetary growth and the removal of rigidities in markets. These were to be supported by tight fiscal policies so that not too much of the burden of restraining monetary growth and inflation fell on interest rates. In addition, there were plans for reducing the size of the public sector so that resources could be released to the more productive private sector. Counter-cyclical fiscal policy and fine-tuning were denigrated—the emphasis was on sticking to medium-term plans in order to give the private sector a stable policy environment. Unemployment was seen as structural, amenable to microeconomic measures which were felt to be the only way to reduce it permanently. The belief in the virtues of market forces extended to the exchange rate and to international economic

policy more generally. Foreign exchange intervention was relatively small in the early 1980s, and the best contribution a country could make to its partners was to put its own economic house in order.

This policy stance was endorsed in a series of communiques, in particular from the IMF's Interim Committee and the annual economic summits. These policies were followed by the major countries with two exceptions. After an initial attempt at following more expansionary policies to counter unemployment, France fell back in line. The rogue elephant, however, was the US. Monetary policy in the US was very tight, at least until mid–1982, and deregulation proceeded apace. On the fiscal side, however, the desire to cut taxes was given priority, as was an increase in defense expenditure, and the US budget deficit expanded rapidly.

These policies helped shape economic developments in the early 1980s. Very briefly, the highlights were:

—inflation fell substantially in virtually all industrial countries; by the mid–1980s some had actually achieved price stability;

—world output stagnated over 1980–82; the subsequent recovery, at a little over 3% per annum on average in the following five years, was sustained for an unusually long time, though growth relied rather too heavily on the US and its unsustainable policies;

—the dollar rose sharply, initially reflecting very high US interest rates and subsequently the recovery in growth and profits, though in the final stages self-fulfilling market sentiment was the dominant factor;

—The strong dollar, lax fiscal policy and the shortage of private savings in the US, coupled with slow growth elsewhere, contributed to a large and growing US trade deficit.

Against this background the chief international economic concerns in the early 1980s were the slow pace of recovery outside the US, and the strength of the dollar and high level of US interest rates; resultant worries included the level of European unemployment and the ldc debt crisis.

The US position was that its policies were basically sound, witness the strong growth and low inflation. This was the reason why

markets priced the dollar so highly—and the judgement of markets could not be improved upon. The dollar could only be lowered if US economic prospects became relatively less attractive—and this was best achieved by stronger growth elsewhere. Damaging the US economy, for example by pursuing a lax monetary policy or by raising taxes, would not help anyone. There were no strong links between the budget deficit and US interest rates and the dollar—however a reduction in non-defence spending in the US would reduce the risk of tax increases.

The *German* and *Japanese* positions were that their policies were very much in accord with the agreed G5 policy line. To them the fundamental problem was the US fiscal deficit. This was viewed as the root cause of both high US interest rates, which dragged up interest rates elsewhere, and the overvalued dollar. The latter was harmful to the non-US G5 because it hindered anti-inflation objectives (via exchange rate effects); furthermore a substantial correction was likely, with the risk of damaging financial consequences. According to this view the US should cut Federal spending or, failing that, should raise taxes.

Attitudes to policy coordination changed over this period. To begin with the emphasis was very much on defeating inflation at home—the best contribution a country could make, both for its own economy and the world economy, was to achieve low inflation. Subsequently, the high levels of both US interest rates and the dollar focussed attention on the linkages between these and interest rates and exchange rates elsewhere. The initial response was to stress the importance of achieving *convergence* in economic policies. By convergence was meant that a harmonious international economic environment would emerge providing the stances of domestic economic policies converged on the norm identified above—*viz*, tight fiscal and monetary policies. Using the language established in Section 1, the "convergence" philosophy implied that broad synchronisation of the overall stance of policies, or absolute coordination, would by itself achieve a settled structure of exchange rates and current accounts, or relative coordination. While this could be interpreted as an attempt to reintroduce a set of rules, the haziness surrounding the specification both of macroeconomic policies and the links between them and balance of payments developments

suggests that this is not a plausible rationalisation. Meanwhile economic collaboration was also reduced, at least among the major industrial countries which ceased to use IMF resources and hence did not have IMF programmes. On the other hand the ldc debt crisis initiated an impressive display of economic cooperation among a wide range of countries; and discussion of international economic analysis and forecasts continued, though with little impact on policies, as noted above.

There is no doubt that the fiscal and monetary policies pursued in the major economies over this period achieved their primary objective of a significant reduction in the rates of inflation experienced at the end of the 1970s. Nevertheless the consequences of the neglect of international economic interactions—in particular the failure to deal with the growing overvaluation of the dollar and the emerging US balance of payments deficit—are now widely regarded as serious. While it has proved surprisingly difficult to find significant harmful effects arising from short-term exchange rate volatility, there is much greater agreement that the massive exchange rate misalignments which arose contributed to large external imbalances, unwarranted structural changes which are difficult to reverse, the growth in protectionist pressures, and to a general climate of uncertainty about exchange rate movements over the longer term. All these factors imply adverse effects on the level of activity and allocation of resources. Furthermore the essential reduction in the US current account deficit is all the more difficult to achieve for having been neglected for so long. Thus it does seem that the comparative neglect of (relative) policy coordination over this period was a significant contributory factor to the very major disequilibria which built up.

2.5 1985 to date

In mid-1985 an important reassessment of the means of achieving US economic objectives took place. The trigger was growing concern that the US Congress would resort to protectionism to counter the weakness of the US trade position. As a consequence, US Treasury Secretary Baker quickly launched two initiatives. The first led to the Plaza Agreement, the aim of which was to achieve a lower dollar. The second initiative concerned ldc debt, the objective

here being the achievement of growth-oriented adjustment programmes in ldcs so as to boost the demand for US exports from that quarter and to keep afloat a number of US banks. These initiatives were entirely US inspired, although their execution required the cooperation of other countries.

It is the Plaza Agreement of September 1985 which is relevant here. In this the G5 Finance Ministers and Central Bank Governors agreed that action to encourage a continuation of the dollar's previous gradual decline, if necessary by intervention in the foreign exchange markets, would be desirable. There was also agreement that current internal and external imbalances should be reduced by effective fiscal measures in the US, by policies to stimulate domestic demand in Japan, and by continued efforts to reduce structural rigidities in Europe. However, no new policy commitments were made. The main significance of Plaza is that it marked a recognition that the unfettered operation of the foreign exchange markets did not speedily produce equilibria in external positions and could have damaging consequences.

With the dollar resuming its decline, the focus of concern switched to the large trade imbalances between the US on the one hand and Germany and Japan on the other. Despite the turnaround in the dollar the US trade deficit showed no sign in 1986 and early 1987 of even stabilising; equally the Japanese and German surpluses were growing strongly, reflecting disappointingly slow growth of domestic demand and large terms of trade gains following the collapse of oil and other primary product prices.

The fiscal policy deadlock continued, with the US irritated by the weak growth of demand in Europe and Japan, and others equally irritated by the lack of fiscal action in the US. The monetary situation was rather different. With no sign of any pick-up in inflation, thanks in part to weak primary product prices, the US was able to undertake an aggressive campaign of interest rate reductions and talking the dollar down—the aim being to achieve a lower dollar and to put pressure on other countries to loosen monetary conditions and boost demand to make their own currencies less attractive. On the institutional side, at the Tokyo summit (May 1986) G7 Finance Ministers agreed to meet at least once a year to review economic objectives and forecasts against a framework of economic indicators; these

indicators included growth, unemployment, inflation, current account and trade balances, fiscal deficit ratios, monetary growth rates, interest rates, reserves and exchange rates. This can be viewed as a further step towards enhancing the role of international policy coordination, especially what we have termed absolute coordination, *ie*, coordination of the overall stance of policies. Nevertheless there is little evidence that such a review has had much impact on countries' policies—this could await the development of a more precise and structured framework against which changes in these indicators could be assessed.

When the dollar had declined almost without interruption for over a year, the focus of concern became one of stabilising the dollar to avert a free fall and an overshoot in the downward direction. Under these circumstances the possibility of a "package deal" of economic measures which might reduce these external imbalances emerged—showing that major countries were prepared, as at the Plaza, to adjust domestic policies taking into account their impact on other economies.

In February 1987 a deal was concluded known as the Louvre Accord. The most significant feature of this accord, it subsequently emerged, was an agreement to stabilise exchange rates around their then existing levels, even though the agreement to "cooperate closely to foster stabilility of exchange rates around current levels" appears only in the final paragraph of the communiqué. The remainder of the published agreement falls into three sections. The first consists in large part of non-controversial statements on economic developments; the second lists economic policies which the individual G7 members (less Italy which declined to take part as a reaction to being excluded from G5 discussions) intended to follow—almost exclusively their existing policies; the last section briefly notes some refinements in the use of economic indicators.

The specific policy undertakings may be summarised as follows:

Canada—remained committed to further progressive reduction of its fiscal deficit;

France—would reduce the central government budget deficit by 1% of GNP from 1986 to 1988 and in the same period would implement a tax cut programme of the same order of magnitude; it

would pursue in 1987 its privatisation programme with a projected $6bn to $7bn sale of assets;

Germany—would pursue policies to diminish further the share of public expenditures in the economy and to reduce the tax burden for individuals and corporations with a comprehensive tax reform aimed at reinforcing the incentives for private sector activity and investment; in addition the Government would propose to increase the size of the tax reductions already enacted for 1988;

Japan—a comprehensive economic programme would be prepared after the approval of the 1987 budget by the Diet so as to stimulate domestic demand; discount rate would be cut by ½%;

United Kingdom—the share of public expenditure in the economy would continue to fall and the burden of taxation would be reduced while public sector borrowing is maintained at a low level;

United States—would pursue policies with a view to reducing the fiscal 1988 deficit to 2.3% of GNP from its estimated level of 3.9% in fiscal 1987; the growth in government expenditures would be held to less than 1% in fiscal 1988.

These policy undertakings, which were generally not new except for the Japanese economic programme and the increase in the German tax cut, were fulfilled with the following exceptions:

(i) the reduction in the French budget deficit between 1986 and 1988 is now put at 0.7%, rather than the 1% of the Accord—a small and uncertain difference;

(ii) the US Federal budget deficit in fiscal 1988 is expected by the Administration to be about 3.1% of GNP ($146 billion), substantially higher than the 2.3% ($108 billion) in the Accord—the deficit for fiscal 1987 turned out at 3.4% of GNP ($150 billion).

Thus the specific policy undertakings were mostly, but not all, honoured. There was, and is, some doubt over the adequacy of the undertakings themselves. Part of the answer is that these undertakings were seen not as once and for all policy changes, but as steps in a direction which would help to reduce external imbalances and to convince the markets that the greater degree of exchange rate stability which was a G7 objective was warranted by the fundamentals.

Almost immediately there was widespread press speculation concerning the existence of a secret agreement which specified ranges

against the dollar which were to be defended. Subsequently it has been suggested* that agreement was reached on midpoint rates between the G3 currencies of 1.8250 DM to the dollar and 153.5 yen to the dollar. By this account, these rates were to be defended by intervention which was voluntary up to plus or minus 2.5% of the midpoint rate, and was expected to intensify subsequently with consultation on policy adjustment obligatory if a 5% band was exceeded. For a short time after the Louvre Accord markets were relatively stable. However, in mid-March 1987 the dollar came under substantial downward pressure once more, due to market perceptions of the lack of progress over reducing G3 external imbalances and fears about US protectionism. This occurred despite large-scale intervention, especially by Japan. At the April 1987 G7 meeting the yen/dollar central rate was rebased to Y146, reflecting developments in the market. For some months the dollar stabilised but following the stock market crash of October 1987, it came under heavy downward pressure again; it only stabilised in 1988 after heavy concerted intervention in the first half of January and with increasing evidence that the US trade deficit had finally turned the corner. Subsequently the dollar started to recover, initiating intervention to limit its appreciation, in line with the Louvre Accord objective of greater exchange rate stability.

It is difficult to draw firm conclusions from an event as recent as the Louvre Accord, which involved a development of policies and undertakings struck at the Plaza, and has itself been further adjusted by more recent G7 statements. Nevertheless we offer the following tentative conclusions:

—since mid-1985 the major industrial countries appear once again to have been willing in principle to adjust their domestic policies taking into account their impact on other economies;

—the commitments to adopt a common attitude to exchange rates (to push the dollar down at the Plaza, to stabilise around "current" levels at the Louvre and subsequent April and September 1987 G7 statements) were supported by policy

*See "Managing the dollar: from the Plaza to the Louvre" by Yoichi Funabashi published in 1988 by the Institute for International Economics, Washington.

undertakings designed to validate exchange rate levels existing at the times the statements were made;

—the policy undertakings have been of an increasingly specific nature, which perhaps reflects that their fulfilment has been less complete than desired or expected;

—undertakings regarding fiscal policy have been more specific than those relating to monetary or structural policies, but have realistically *not* amounted to a coordinated fiscal strategy;

—shortcomings in the implementation of fiscal policy reflect both the failure of the US political process to implement significant deficit reduction measures, and serious analytical differences regarding the effects of expansionary measures in Germany and, to a lesser extent, Japan—arguably the US impasse also reflects analytical differences;

—publicly expressed differences of view between participants during periods of exchange rate pressure have undermined the credibility of the agreement; the latter also depends on continued evidence that the necessary adjustment in current account imbalances is taking place;

—the logical next step in the Plaza/Louvre continuum of closer policy cooperation would be to seek agreement on a means of periodic adjustment of the basic exchange rate relativities around which it is desired to establish greater stability by reference to fundamental economic relationships rather than merely in response to market pressure.

2.6 Summary

To conclude this section we attempt to summarise some of the factors which have contributed to the success or otherwise of policy coordination in the post-war period. We divide these into three broad groups: degree of agreement over how economies work; consensus or otherwise over objectives; and political factors.

Agreement over how economies work. There seems little doubt that uncertainty makes policy coordination much more difficult to

achieve. Whatever the apparent consensus in public among policy makers, there have been serious disagreements over key economic linkages during the 1980s, for example the dispute between Germany and the US over the appropriate stance of fiscal policy; the argument within the US over the best way to reduce the Federal deficit also has its origins partly in analytical differences. As we noted earlier, the Bonn summit deal of 1978 was held up for some time by arguments over whether fiscal expansion in Germany would actually boost growth there, and the deal was only finalised when opinion in Germany shifted on that issue. This is not to argue that the Bretton Woods era was one of complete analytical consensus. However, by and large there was at least a consensus over the direction in which economic variables would change following some disturbance. In part the greater uncertainty of recent years reflects the growing importance of financial markets—our ability to predict both developments in these markets and how they affect other markets is far from perfect.

Conflicts over objectives. It is important to distinguish between conflicting interests and interests which differ. The latter, far from being a constraint on coordination, may actually assist it. For example, it can be argued that the Bonn package was facilitated by the presence of diverse objectives, including energy, macroeconomic and trade objectives, which created sufficient trade-offs for a deal to be possible. Conflicting interests, however, would appear to be an unambiguous barrier to coordination. However, it is far from clear that such conflicts have increased over time. As we saw, the 1979–85 period, which was largely devoid of policy coordination over balance of payments interactions, was marked by an impressive consensus of view, at least in public statements, over the objectives of macroeconomic policy. Nevertheless important differences still remain—it is clear, for example, that the Germans attach greater importance to controlling inflation than does the US.

Political factors. Failure to reach objectives can arise from a number of causes. The quality of preparation behind an attempt at policy coordination is clearly important. One of the lessons from the Bonn summit was the contribution of the painstaking background

work by both national and international civil servants. Political factors can also play a key role in the success of policy coordination, including the closeness of the leaders of the summit countries and the stage of countries within the political cycle. In this context, it is important to recognise that the key macroeconomic decisions are taken by politicians who will be as much influenced by their domestic objectives and problems, and by their political freedom of manoeuvre, as by strictly objective economic considerations. Their own outlook and background will also be relevant. This applies most obviously in the case of summits; and the situation in 1977 and 1978 when six of the eight summit leaders were former finance ministers with a broadly similar attitude to demand management and a personal interest in the technicalities is perhaps unlikely to be repeated. Nevertheless, at any one time the mosaic of domestic political objectives, and in particular the balance struck between the three objectives of growth, social welfare and counter-inflationary concerns, may lead to differing national emphasis on the need for mutually supportive action and varying willingness to participate in it. This is an inevitable consequence of the democratic system and it does not mean either that economic orthodoxy must always be subordinated to political imperatives or that policy coordination must necessarily be a hit and miss affair. It does however suggest that it is probably impracticable to attempt to devise an "ideal" system of policy coordination which will be suitable for all times and all governments, and that we should do better firstly to minimise the need for discretionary coordination and secondly to identify the kind of coordination which will be most effective.

From this account of policy coordination in the past certain conclusions can be drawn and these are suggested in the next section of this report. We have no doubt that some degree of effective policy coordination is desirable in addition to that which may flow imperceptibly from, for example, discussion in multilateral bodies of economic forecasts. It is not, however, an exact science and experts differ on the importance to be attached to it and on the way it is best achieved. On the other hand, if the argument for policy coordination is an imperfect one, the general case against it is difficult to sustain in an increasingly interdependent world.

3. The Future Contribution of Policy Coordination

Our review of the history of policy coordination since the war suggests that coordination is the norm rather than an isolated event—periods of non-coordination are the exception rather than the rule. Indeed even the years 1979–85 can be identified as a time of coordination on the macro-policy front in the sense that the major countries jointly agreed on the need to give absolute priority to getting inflation under control. There is an underlying revealed preference for coordination. This is not so surprising given the presence of spillover effects among economies and the growing interdependence of the world economy. At the same time policy makers in general do not consider that they have an abundance of policy instruments with which to achieve their objectives, especially as fiscal and supply-side policies are either set in the medium term or can take a long time to affect the economy. This helps explain the rational interest in policy coordination as an aid to easing external constraints on domestic policies.

The case against the coordination of economic policies among the major economies has been made in a number of quarters and the exact arguments deployed vary somewhat from case to case. Nevertheless it is possible to pick out some common strands which would probably find support among those arguing against coordination. A popular starting point is the belief that a country has the right to choose its own blend among economic targets such as inflation and growth and, in particular, that countries with a strong preference for low inflation rates should not be forced to follow more expansionary

policies just to bring them into line with others. Next there is the view that a country's inflation rate is determined principally by the stance of its own economic policies with the exchange rate playing a subsidiary role; a corollary of this argument is the belief that active management of the exchange rate is 'putting the cart before the horse' and can prejudice the success of fiscal and monetary policies. Finally, there is the view that unmanaged exchange rates do not have particularly costly or undesirable side effects.

Though these various arguments can at times appear persuasive some important counter-points can be advanced. With respect to the first argument, we would stress that policy coordination, especially that centred on exchange rates, cannot take place in a vacuum with respect to the absolute stance of policies being pursued. Thus it is necessary to have general agreement about the overall stance of policies; it is in this context that the recent interest in economic indicators among the G7 is very relevant. Furthermore, if any country disagreed strongly about the prevailing consensus on the general stance of policies it could allow its exchange rate to either appreciate or depreciate, according to the circumstances, so as to help achieve a different inflation rate from the average. This would, however, preferably be achieved in a managed fashion and with the agreement of other countries.

The second counter-argument—that attempts to manage exchange rates can distort and frustrate the thrust of monetary and fiscal policies—assumes that domestic and external policies tend to be in conflict, and that exchange rate or balance of payments developments tend to give misleading signals for domestic policy, at least when exchange rates are managed. This is one of the issues which we suggest should be examined in detail (see Section 4). For the moment we stress the positive role that balance of payments developments can play in assessing domestic policy, not least when interpretation of monetary and fiscal developments can be obscured by structural changes.

Finally, we disagree strongly with the argument that the costs of exchange rate movements which are subsequently reversed can be disregarded. As we have argued above, the gross misalignments of some exchange rates have proved to be very costly, which suggests that there is a strong case for seeking to influence exchange rates so

as to avoid the sort of misalignments which have characterised the 1980s.

All this said, policy coordination is difficult to achieve, even at the best of times. The obstacles to coordination—the inability to agree on how the world works, conflicts of interest between countries, the various policital constraints, etc.—can be so significant as to either prevent it taking place or severely limit its role. Furthermore it would be unwise to assume that these obstacles to coordination will be materially reduced in the foreseeable future, a point elaborated on below. On the other hand we feel that some of the problems with policy coordination can be exaggerated. For example, the costs of undertaking the process of coordination may not be that high, given the plethora of international fora presently existing in which national officials and ministers can discuss mutual concerns (see Annex). Similarly the threat that parties to a policy bargain will renege on their commitments can also be over-stressed, as the follow-up to the first Bonn summit shows.

Before outlining possible approaches to policy coordination we first consider some *pointers on the likely structure of the world economy* which could have a bearing on the form coordination might take:

—the emergence of three major economic powers (the US, Japan and Germany) means that the process of arriving at agreement among the major countries will continue to be more complex than during the Bretton Woods era;

—nevertheless the participation of each of these three is still essential, and experience shows that policy initiatives which have US support tend to be among the more successful;

—financial markets are unlikely to become any less powerful or easier to control, least of all by quantitiative means;

—the inability to agree on how the world works may continue to pose serious obstacles to coordination in the future (for example, the present dispute between Germany and the US on the appropriate stance of fiscal policy in supporting economic growth is in many respects a re-run of the 1976–78 debate);

—in several aspects the world economy is now more stable than at any time since the 1960s. For example, inflation is low in all the major economies, and there is a close consensus on the appropriate general stance of economic policy;

—however further major shocks to the world economy cannot be ruled out—for example it is not yet clear that the US balance of payments deficit is improving sufficiently quickly and the dollar could come under sustained downward pressure again.

The last point is very important and deserves some amplification. Most major world economic forecasting exercises are projecting a continuation of the pattern of low inflation and moderate growth which has characterised the major economies for some time now. At the same time they stress the major uncertainties which still surround such forecasts. These uncertainties include the possibility that the ldc debt situation could errupt again; a further sharp change in the oil price cannot be ruled out; and non-oil primary product prices may have become more volatile following several years of comparatively low real prices which have discouraged investment in such commodities. Nevertheless the major uncertainty is still the possible evolution of the US twin deficits and the dollar. Although the substantial devaluation of the dollar appears to have restored the competitive position of the US, the size of the US fiscal deficit in relation to private savings is still producing a large and continuing current account deficit. Despite more recent developments which have been interpreted as favourable to the dollar and which have resulted in upward pressure, at some point confidence could again break down, resulting in renewed and sharp downward pressure on the dollar.

The essential point is that were any of these shocks to materialise their impact among economies would be very different, leading inevitably to balance of payments and exchange market pressures. There are two implications for future policy coordination. First, there will be a continuing need for crisis management. Second, any structure or system of coordination will have to be robust and flexible enough to survive such shocks if it is going to play a durable role.

Taking account of the above points, and drawing on our review of the history of policy coordination and the nomenclature established earlier, we are led to suggest *three basic options* for the *future shape of policy coordination*:

1 to coordinate only on a discretionary basis;

2 to return to a rule-based system of coordination, with the emphasis on coordinating either policy targets or instruments;

3 to return to a rule-based system of coordination, with the emphasis on a more managed exchange rate system.

The *first* option is basically to carry on as we are with discretionary coordination to cope with problems as they arise. By its nature this approach to policy coordination tends inevitably to concentrate more on crisis management than on crisis prevention. In some circumstances—for example when the system is subject to a severe and unexpected shock—this is a necessary component of coordination, but it would seem to be highly desirable that it was not the *only* form of coordination. Some of the problems affecting the world economy have been widely predicted, the most obvious recent example being the problems associated with the overvaluation of the dollar. By its nature, the crisis management approach only produces a policy response when the crisis has occurred—the need to avert or reduce the magnitude of incipient problems suggests that the discretionary approach should be improved upon if possible.

At the same time the discretionary approach to policy coordination can generate its own problems. In Section 2 above we reviewed in some detail the 1978 Bonn deal which is the high point of this type of coordination. Although the Bonn package deal had significant positive aspects, the fact remains that it also generated dissatisfaction among the participants. In part this reflects the protracted bargaining necessary to produce the resulting agreements; the length of time involved can mean that the agreement is obsolete almost as soon as it is reached. More formal rules of the game which are credible and enforceable would provide participants and markets with a firmer basis for their actions and expectations.

We now turn to the *second* option which, to return to a key distinction made throughout this report, involves setting up a rule-based system of policy coordination rather than relying on a series of discretionary policy agreements. The central advantage of a rule-based system is that adherence to the rules can make it more difficult to postpone or avoid making necessary policy adjustments.

However, a generalised macroeconomic rule book is extremely difficult to establish on an international scale. In the first instance, there must be agreement on the economic variables to be subject to rules. One option is to select *policy targets*, for example growth (as in the London economic summit of 1977) or inflation (as was implied by the convergence effort of the early 1980s). The problem here is that the links between such target variables and the instruments actually controlled by policy makers can be very tenuous—to the extent that there can be disagreement over the direction in which an instrument should be changed to achieve a given target (as in the US–German dispute over fiscal policy, noted above). Such difficulties may be reduced if inflation is chosen as the target—but, equally, convergence on low inflation rates has not prevented the emergence of serious international economic tensions over the past few years.

Another variant of this option would be to make some of the *policy instruments* the target variables. For example, countries could agree to maintain fiscal deficits as a proportion of GNP or monetary growth within a certain range. However, because of the very different economic and sectoral structures among countries, it is difficult to conceive of simple fiscal rules which would make any sense—the rules would have to differ among countries to allow for these heterogeneities. Equally, financial innovation and deregulation have made the interpretation of monetary and credit developments very hazardous, even within one country. All this is not to imply that traditional policy instruments have lost all potency—simply that they are not a suitable hook on which to hang policy coordination.

It is possible to conceive that the approach through indicators—launched at the Tokyo summit of 1986, and refined in subsequent summits—could be a step towards a rule-based system hinged on policy targets or instruments. However we do not detect any impetus to make the indicators a basis for rules, for example

through reaching prior agreement that a certain divergence of indicators would trigger a certain policy response. Indeed we have suggested that such rules would be difficult, and perhaps impossible, to formulate with sufficient clarity and precision. At this stage it is more appropriate to think of the indicator approach as providing a framework for considering discretionary coordination.

The obvious basis for rule-based policy coordination, then, is the *exchange rate*, which is the *third* option. The exchange rate is unambiguously defined, with instantaneous data available. It is the single most important price in the economic system. It is also a key link between economies. Indeed, as we have already noted, it was the concern over the consequences of the substantial exchange rate misalignments which built up over the years to 1985 which triggered the recent interest in policy coordination. Thus, using the exchange rate as a focus for coordination could provide a helpful steer to markets as well as reducing the need for more *ad hoc* forms of coordination. Of course, attempts to introduce greater stability into exchange rates would have important implications for other policies, notably intervention and monetary policy, but also fiscal policy. What is crucial is that countries participating accept these implications. The EMS suggests, however, that it is not necessary to set up explicit machinery for coordinating fiscal policy.

There has been substantial experience of exchange rate based systems in the post-war period: globally with Bretton Woods, regionally with the EMS. Both required a considerable political and technical effort to establish, but displayed a good degree of durability once in place. The Plaza Agreement and the Louvre Accord have once again focussed on exchange rates. The discretionary element remains high, and it could not be purported that we are close to a rule-based system. Nonetheless, the Plaza and the Louvre can be visualised as the first steps towards such a system. They offer a basis on which it would be desirable, and may be possible, to build. This is the proposition which is explored in the final part of this paper.

4. Conclusions, and a Way Forward

Our analysis so far leads us to the following conclusions:

—Policy coordination is desirable to secure the mutual easing of the constraints on national economic goals arising from economic developments and policies in other countries.

—While policy coordination has had its successes it has not been as effective as it should be.

—The cause of this is not a shortage of coordinating machinery (the Annex lists the various bodies involved in one way or another with coordination).

—It is due rather to:

(a) lack of political conviction or commitment to the process;

(b) differences about the best method of avoiding misalignments and imbalances.

—The time is not therefore ripe for a quantum jump or a new blue-print. It is however an opportune moment for debate and a cautious move forward.

—The more policy coordination can be a continuous process rather than a form of crisis management the more effective it is likely to be. Hence our preference for relying on a rule-based system to the maximum extent possible.

—Any rule-based system must take the exchange rate as its starting point. This does not mean however that a new Committee of Twenty is called for or that it would be any

more successful now. Nor does it mean that exchange rate linkages are always more important to policy coordination than other aspects or instruments of macroeconomic policy. The exchange rate is however the single most important price in the economic system and is a key link between economies. This makes it the natural focus for international policy coordination.

If we do not believe that the time is ripe for a quantum leap, how then do we see the way forward?

In addressing this question, we start from a recognition that a decision to re-establish a system based on rules would be a political one which could only be credible if taken at the highest level. In part, this is because such a decision would have ramifications extending far beyond the responsibilities and competence of individual ministries, let alone central banks. Moreover, there is a risk that the system would function ineffectively or even collapse. That risk could only be assumed on the basis of a full political commitment.

It is not possible even to guess whether the climate for such a commitment will emerge. It will of course be more likely to emerge the sharper becomes the appreciation of the costs, actual and potential, of continuing with present arrangements. But experience with policy coordination suggests that dissatisfaction with existing arrangements is not enough: there will need to be a particular conjuncture of political and economic forces and pressures which will persuade those who are laying their own credibility on the line that the risk is one which they, as individual leaders, are prepared to assume. Again, experience suggests that it is likely that the establishment of a rule-based system will require the active support of the USA and that, at a minimum, the cooperation of Japan and Europe will be necessary. In short, the hurdles at the political level are high.

From the Plaza onwards, there have been clear signs of heightened interest in a more structured system based on exchange rates. Over the same period, however, there has also been an increased awareness of the difficulties, within and between countries, of operating a Louvre-type arrangement under which a greater degree of stability of exchange rates is an objective, but which

incorporates no public exchange rate commitments. Indeed the firmness of the covert commitments to exchange rate stability appear to differ between countries and over time.

It is possible that those difficulties could lead to a *de facto* erosion of the Louvre Accord and a return towards a situation in which exchange rates are free to move under the impact of market forces. But there is also a possibility that the thrust initiated at the Plaza and extended at the Louvre could be strengthened, and that the Plaza and the Louvre could find their place in history as stepping stones on the way towards the more structured system which we commend.

The erosion of the Louvre Accord requires no action; neglect will suffice. But its strengthening and, even more, a move towards a more structured system, does require action, starting with a programme of work to identify the options and alternatives available. Such a programme would need to address a wide range of issues, and can be initiated without any commitment to a more structured system: indeed it would be foolish to enter any commitment until the full economic and political implications had been explored. Moreover, much of the work envisaged would serve a Louvre-supporting purpose. It may reveal further actions and initiatives which would help to promote a more effective management of exchange rates, even if the obstacles in the way of moving to a formally structured system prove for the time being to be insurmountable.

As an example, consider the case for reviewing intervention arrangements. Since the Plaza Agreement a major role for official intervention has been recognised. The Louvre Accord required a strengthening of that role. Intervention has certainly been extremely heavy at times. The general impression given by such information as has become available is that there have been occasions when intervention has been concerted and effective, and others when for various reasons the results have been less positive. The time may have come when a thorough review of the present arrangements and techniques could be helpful. This might address, inter alia, the issues of burden sharing, of the currency of intervention, and of the case for drawing some distinction, as in the EMS, between intervention funds deployed for short periods and those available for longer. A thorough appraisal of techniques and effectiveness (as was undertaken in a very different climate of opinion following

the Versailles Summit in 1982) could be helpful in assessing the possibilities and limitations of a Louvre approach. It might point to changes in facilities and techniques which could beneficially be introduced in advance of any more formally-structured system. It would of course be an essential preparation for such a system.

Also relevant in a Louvre context are questions of the roles of monetary and fiscal policies, and the possible limitations on their use in pursuit of domestic objectives. Events in several countries recently have demonstrated that these questions have lost none of their sharpness. It is commonly supposed, but is not necessarily true, that such conflicts would become even more acute in a more structured system. There are trade-offs, but the view that greater exchange rate stability would imply a subjugation of domestic policies to external requirements is as incomplete as the view that free floating would liberate domestic policies from external requirements. History seems to suggest that whilst gross incongruities in fiscal stances need to be avoided if misalignments are to be avoided, a measure of fiscal independence may be compatible with exchange rate stability. The freedom for manoeuvre on monetary policies may however be smaller. At any point of time it will be tempting to maximise national freedom for manoeuvre. What needs to be explored—in practice as well as in words—is what are the costs of that freedom.

Inseparably related to questions of domestic policy constraints is the issue of how policy adjustment should be shared between countries with currencies tending to appreciate and those tending to depreciate. Experience in the latter phases of the Bretton Woods system, within the EMS, and indeed under the Louvre Accord, suggests that this will perhaps be the most politically difficult aspect of any structured scheme.

In turn, issues of policy adjustment lead on to the arrangements for surveillance. They are also closely linked to the difficult question of how any structure based on relative magnitudes (exchange rates) should be anchored, *ie*, how the need to avoid significant policy errors at the aggregate or global level is taken into account in achieving exchange rate stability.

There is in short no lack of extremely awkward and contentious questions which need to be taken forward. Progress towards resolving them could be helpful in bolstering the ability of the authorities

to fulfil their declared intention of achieving a greater measure of exchange rate stability through a Louvre-type arrangement. Beyond that, they are issues which need to be resolved before a more formal scheme can credibly be considered.

It is not the intention here to offer a full agenda of preparatory work, but mention must be made of one issue which is of far greater importance today than it was in the last days of Bretton Woods. Channels for international private capital flows have deepened, and actual and potential flows are heavy. An exploration of whether there are any practicable ways of limiting or neutralising the undesirable side effects of these flows is relevant to the Louvre arrangements, and crucial to any more formal system.

The most obvious difference between the Louvre arrangements and a formal exchange rate structure is the nature of the exchange rate commitment. Under a Louvre approach the exchange rate objectives are not publicly specified, and the means through which governments propose to achieve such objectives are not made known. Markets are not told whether any bands for exchange rates are agreed, whether any bands there may be are wide or narrow, whether the edges to such bands are hard or soft, or what arrangements there may be for changing the position of the bands. Naturally these are matters of lively interest to markets, and they make guesses which from time to time generate pressures in markets. Under a rule-based system, exchange rates, bands, and the arrangements for change would be overt. But there remains a broad spectrum of choice, and the character and bite of a scheme is entirely determined by the choices made. The system could be tight, designed to hold nominal rates within narrow bands, with changes in parities not easily made. Or it could be relatively loose, with parities defined in real or indicative terms within broad bands, and with parity changes more readily accepted. A further and important dimension of choice is provided by the possibility that links between some countries could be looser than those between others. An obvious variant for consideration would involve looser links between the USA, Japan and Europe, than those established within Europe and perhaps other zones.

The range of options for examination is wide. How should these be analysed, and by whom? It seems unlikely that attempts to address

the whole range of issues in a single forum would be the best approach. Such a procedure would imply a considerable degree of commitment by participants and would inevitably raise expectations. It might perhaps be better to assemble the blocks out of which an exchange rate system would need to be built by exploring the various issues in separate groups, drawing upon different expertise.

We do not underrate the magnitude of the decision which would be involved in a commitment to a formal rule-based exchange rate structure. It would call for high statesmanship as much as financial judgement. But the political will was there at the time of Bretton Woods and it is by no means impossible that the conditions for such an act could emerge. Indeed there is a detectable tide running in that direction. The fact that it is not at its flood is good reason for undertaking work which could in due course facilitate a major step forward in international policy coordination.

ANNEX

INTERNATIONAL ECONOMIC MEETINGS

	Group	Level of Representation	Frequency	Secretariat
(a)	Economic Summit	Heads of State/ Government (Preparation by Sherpas)	Annual: May/June	No permanent secretariat.
(b)	G5/G7	Finance Ministers, senior officials and central bank Governors	Twice yearly: Spring and Autumn Additional meetings *ad hoc.*	No permanent secretariat.
(c)	G5 Deputies	Senior officials	Twice yearly: Spring and Autumn Additional meetings *ad hoc.*	No permanent secretariat.
(d)	G10	Finance Ministers and Governors	Twice yearly: Spring and Autumn	Tripartite Secretariat (IMF, OECD, BIS).
(e)	G10 Deputies	Senior officials and central bank representatives	Twice yearly in advance of IMF meetings; but also *ad hoc.*	Secretariat: as for Ministers and Governors.
(f)	IMF Interim Committee	Finance Ministers or Governors	Twice yearly: Spring and Autumn	IMF.
(g)	IMF/World Bank Development Committee	Finance Ministers and/or aid Ministers	Twice yearly: Spring and Autumn	IMF and World Bank.

	Group	Level of Representation	Frequency	Secretariat
(h)	IMF/World Bank Annual Meetings	Finance Ministers and others	Annual: Autumn	IMF and World Bank.
(i)	OECD Ministerial	Ministers—Finance, Trade, Foreign Affairs	Annual: May/June	OECD.
(j)	OECD Economic Policy Committee	Senior officials and central bank representatives	Twice a year, plus occasional *ad hoc* meetings	OECD.
(k)	OECD Working Party 3	Senior officials and central bank representatives	Three times a year	OECD.
(l)	ECOFIN	Finance Ministers	Usually monthly	EC Commission.
(m)	Monetary Committee	Senior officials and central bank representatives	Approximately monthly	EC Commission.
(n)	Committee of EC Governors	Governors of EC	Monthly (except August and October)	BIS.
(o)	Committee of Governors	Governors of G10	Monthly (except August and October)	BIS.

Notes

(a) Seven summit countries: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. Sherpas: personal representatives of the heads of state or government. Financial sous-sherpas (the G5/G7 Deputies) also play a role in Summit preparations.

(b) and (c) The G5 includes France, Germany, Japan, the United Kingdom and the United States. The Tokyo summit communiqué defined the roles of G5 and G7 as follows: "The Heads of State or Government request the Group of Five Finance Ministers to include Canada and Italy in their meetings whenever the management or the improvement of the international monetary system and related economic policy measures are to be discussed and dealt with."

(d) and (e) G10: G7 + Belgium + Netherlands + Sweden + Switzerland.

(f), (g) and (h) Meetings held in Washington except one year in three when the Annual and its associated Autumn meetings are held elsewhere (1985: Seoul; 1988: West Berlin; 1991: Bangkok).

(f) Membership of the Interim Committee: 22 Governors of the Fund.

(g) Membership of the Development Committee: 22 Governors of the Fund or Bank.

(h) All IMF and IBRD Governors.

(i) OECD members are Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States and Yugoslavia.

(j) All OECD members plus EC Commission, IMF, World Bank and the BIS are represented at EPC.

(k) G10 (including Switzerland) are represented at the WP3, whose terms of reference are to analyse the effect on international payments of monetary, fiscal and other policy measures and to consult together on policies to promote better international payments equilibrium. Attended normally by G10 Deputies.

(l), (m) and (n) The 12 members of EC are represented at ECOFIN, Monetary Committee and Committee of EC Governors.

(o) G10, including Switzerland.

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R5025-1.21 F 10/69

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An earlier version of this paper by John P. Hardt and Sheila N. Heslin was presented at a Plenary Meeting of the Group of Thirty in Madrid in May 1989. Oleg Bogomolov contributed to the discussion at that meeting. Publication does not imply endorsement by the Group of Thirty of the views expressed.

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Published by
Group of Thirty©
New York and London
1989

Perestroika: A Sustainable Process for Change

by John P. Hardt and Sheila N. Heslin

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1. Perestroika in Transition*

Since Gorbachev came to power in 1985, perestroika has evolved into a programme which both identifies the failures of the Soviet politico-economic and strategic model and conceptualizes a view of a future Soviet state with market-oriented and participative underpinnings. It sets forth a comprehensive strategy for political, economic and social reform based on the democratization and decentralization of political and economic institutions; increased openness and public participation in decision-making; modernization based on technological restructuring; and a new foreign economic strategy based on interdependence. These components may be seen as interrelated catalysts used to promote change within a larger context of comprehensive reform and a future vision of Leninist market socialism. While progress in one aspect of reform is likely to stimulate progress in other areas, the same synergistic process may escalate in reverse, with negative results. Since costs, particularly economic and social, will outweigh benefits in the short term, the timing and interrelationships of the various elements have become crucial.

Sharp and important differences on the comprehensiveness, pace and structure of change exist among the leadership and the populace and competing political factions have seized opportunities to highlight the costs of opponents' programmes. Thus, as economic performance has lagged and ethnic tensions have increased, conservatives who have not set forth a viable programme of their own to address the country's crisis have nevertheless gained support for a less radical perestroika which

*The views expressed in this paper are those of the authors and do not reflect the views of the Congressional Research Service or those of the United States Congress.

undertakes gradual economic change and modest democratization. At the same time, the most radical reformers have been vocal in calling for a rapid acceleration of perestroika. These developments, many believe, have brought the sustainability of perestroika into question. So far, Gorbachev has succeeded in weaving a course between the most radical reformers and conservative "old believers" by purging many opponents of perestroika from positions of power and using the benefits of political liberalization to compensate for the economic and social costs of reform.

At each step, Soviet leaders must take calculated risks and make short-term adjustments without veering from the intended long-term strategy of reform. In doing so, decisions must be made regarding the following questions: Should the Soviet authorities continue to push for quality over quantity even when stores are empty? Should they allow firms to go bankrupt? How should they deal with the unemployed? How can the Soviet economy provide an adequate supply of goods to consumers during this initial phase if Western credits are limited and Soviet production is down? Should the Soviet Union spend scarce hard currency on Western technology to restructure Soviet enterprises or to meet consumer expectations with increased supplies of goods? How much are average Soviet citizens willing to endure for the benefit of future Soviet generations? These dilemmas, in turn, generate a host of policy issues which essentially centre on overhauling the fundamental Soviet system. The resolution of these dilemmas will determine the long-term outcome of Soviet reform.

Rather than focus on whether Gorbachev and perestroika will survive long enough to change the Soviet system irreversibly, the focus of this paper is on the process itself: it outlines Gorbachev's plan, identifies the dilemmas which Soviet reformers face in implementing reform, and highlights ways to think about trade-offs in the reform process. It also offers some advice for future Soviet policy-making by drawing on experiences of Western and socialist nations attempting to modernize in a changing global economy.

2. Political Reform

2.1 Democratization and Glasnost

General Secretary Gorbachev has stressed the necessary precedence of political reform—particularly with regard to the legal and institutional framework—over economic reform. Political reform in the Soviet Union has proceeded on both top-down and bottom-up tracks. The first track seeks to institutionalize democratic centralism, so as to strengthen governing authority and legislative power to the point where reform leaders could indeed implement reform from the top down. The second track, involving democratization and glasnost, seeks to increase citizen participation. Soviet reformers hope that legal reform will promote the evolution of Soviet society, postponed and distorted by and since Stalin. Institutionalization of the rule of law is meant to embody a collective understanding of the rights and obligations of both the Soviet state and its citizens.

At least part of the rationale for top-down political reform stems from Gorbachev's desire to put the Communist Party at the head of reform and thereby ensure its leadership role in the future. Nevertheless, the bottom-up reforms, most notably the introduction of multi-candidate elections, has circumscribed that role. The election process went a long way towards legitimizing the leadership of pro-reform Party officials, and it also facilitated the elimination of old believers who were rejected by the voters. Thus Gorbachev has made clear that Party officials may stay in power only by responding effectively to the concerns of the population. By extension, the same is true for the Party itself as the vanguard of change.

Soviet leaders are promoting democratization to widen the

participation and initiative of Soviet citizens. On the macro level, citizen participation in economic decisions is crucial in bolstering society's willingness to accept and support changes that may be onerous to many citizens, particularly in the short term. Soviet reformers seem to have taken the calculated risk that average citizens will endure the necessary short-term economic losses in return for political liberalization. On the micro level, democratization and glasnost are meant to increase worker productivity and ultimately, the productivity of the whole Soviet system. The human factor—the latent productive potential of a stimulated and engaged populace and labour force—is to provide a social engine for improving efficiency. Soviet reformers appear to believe that workers and peasants will be significantly more productive if they have more control of the production process and can expect greater returns for increased productivity. They have been offered several opportunities to exercise more control, involving opportunities to choose plant managers, to participate in producer or consumer cooperatives, to share in leased industrial enterprises, to lease agricultural land, and to decide on production, distribution and sales.

2.2 Institutionalizing Glasnost and Democratization

Politically, glasnost has translated into the release of dissidents and prisoners of conscience, a review of the criminal code and the rehabilitation of controversial figures. In addition, a broadening of the agenda for public debate encouraged by Soviet leaders is expected to make elected officials more responsible and accountable. The most immediate effects of glasnost have been evident in the political arena. For the most part, Soviet citizens campaigned openly during the election process, and the secret ballot allowed them to express their will freely. The Soviet people are considered to be Gorbachev's major allies in reforming the system.[1]

Gorbachev has re-defined the role of the Party and re-vitalized the legislature to produce a separation of powers. The reconstituted Supreme Soviet, chosen from candidates by secret ballot, is to meet for 3-4 months in the Spring and Fall of each year and have the power to vote on a wide range of issues, purportedly to include budgets, new investment prospects, and deployment overseas. A more informed and accountable parliament, and local soviets participating more actively in economic affairs, are likely to have a considerable impact on future policies.

Gorbachev has another purpose in encouraging democratization at

the local level—to reduce bureaucratic authority by increasing pressure from below. Elections at the local level, particularly in the wake of substantial party losses in the national elections, are viewed as a means of empowering the people and encouraging reform. In addition, there are to be popular referendums on regional political and social issues, and citizens will have the right to appeal against decisions of the Communist Party in the courts. These initiatives are seen as precursors of a thorough-going purge of old believers at the regional and local levels.

Gorbachev's concept of glasnost and democratization appears to draw upon his version of Lenin's democratic centralism: debate on the conduct of perestroika is to be open and extensive, continuing until a consensus or Party decision is reached. Once a decision is reached, however, it must be accepted until or unless the issue is opened again by the top Party leadership.[2] It is the responsibility of the leadership to make necessary adjustments in the implementation of reform, to exercise constant oversight to keep the process on course, and to encourage effective consensus-building between Party factions as well as among the vast array of Soviet citizens. Even with modest results, the process of top-down guidance and bottom-up participation may mobilize support for Gorbachev's radical revolution, as average citizens gain a stake in the process.

2.3 Renewal and Cultural Reform

Renewal has several aspects. First, it sets limits to change by invoking original values to provide legitimacy for the Leninist system and justification for the main lines of past development. By returning to original values, the Soviet Union can return to the "proper" Leninist course. To retain their positions of power and influence, bureaucrats and Party officials must respect Leninist principles, including the revised, broader view of Leninist democratic centralism.

Equally important, renewal may allow for the development of an indigenous model for comprehensive reform, rooted in the unique history of the country and appropriate to the specific resource endowments of the Soviet Union. To many reformers, return to these historical roots means a revival of traditional religious practices; an acceptance of ethnic diversity and of minority rights; toleration of some degree of self-determination; and a return to the tradition of civil law based on the Napoleonic code designed to establish the rule of law. By creating a new social contract, whereby individual civil rights are granted from above, Gorbachev is

challenging the population to get involved in an attempt to promote a surge of reform from below.

Renewal also allows Soviet historians to open for discussion past traumatic political events, such as the mass murders which took place under Stalin, previously ignored or reinterpreted to suit the Party leadership. Soviet leaders are themselves reopening the debate on history, with the objective of placing responsibility for revisionism and the deformation of Leninist principles on Stalin and Brezhnev. Moreover, this process highlights Gorbachev's position that the doctrines of Marx and Lenin are relevant for analytic purposes but must be applied selectively, taking into account new realities in current and future scenarios.

In pursuing renewal, Gorbachev perhaps realizes that economic reform depends very much on teaching the individual Soviet citizen, who must learn to take initiatives and risks, that past government mistakes are neither condoned nor any longer tolerated. Soviet reformers have increasingly come to realize that the full utilization of Soviet resources requires a more open, equitable system and not just a more aggressive application of control by the military-scientific establishment. Soviet reformers have acted to improve human conditions, if not in the marketplace then in liberalizing social conditions. Modifying policies that discriminate against ethnic and minority groups, providing equality of opportunity, and allowing cultural and religious freedom are seen as a means both of slowing the exodus of people and bringing highly productive citizens back into society. Although the limits and pace of change are not precisely delineated, Gorbachev and close advisers such as Bogomolov emphasize a vision of a Soviet society that will be more pluralistic and similar to modern Western societies than to the early visions of Marx and Lenin. Whether limits can be set by reformers' visions is a question raised by historical experience.

2.4 Implementation of Political Reform

Several observations may be made about political and cultural reform in the Soviet Union. It has not resulted in replacing the dominant role of the Party at the pinnacle of power or reducing its guiding role in central strategic economic planning. In fact, Gorbachev has on several occasions emphasized the leading role of the Party and the value of top-down reform.[3] At the same time, both Soviet and Western observers have noted that Gorbachev has strengthened other power centres too. Only after consolidating power and deepening the process of reform did Gorbachev

reveal plans for greatly circumscribing the future role of the Party. Gorbachev similarly positioned himself at the top of the Party and of a revitalized government, enabling him to build consensus for reform policies unpopular with more conservative power centres (typically the Central Committee). He tapped support from other power centres such as the government and the state and local authorities, and from enthusiasm generated at the popular level. While reform continues to aim at limited political pluralism and partial economic decentralization, the newly created political structures headed by a brilliant political tactician make the political system a potentially powerful vehicle for implementing radical reform.

The process of political reform may also be notable in foreshadowing the pattern of reform which Gorbachev will employ in the future. When he first became General Secretary, few of his public comments addressed specific aspects of political reform—particularly reform of the party. Only gradually did he begin to reveal that the party might play a very different role in Soviet society, that elections would reflect the mandate of the people, that a truly representative legislative body would emerge, that there would be a clear separation of powers, and that the leading role of the party would have to be earned, not imposed. Only as reform deepened has Gorbachev's direction become clear. Looking back, it appears that Gorbachev may indeed have proceeded according to a deliberate plan in implementing the vague outlines of political reform at which he hinted early on. Certainly, as a brilliant political tactician, he knows that not announcing a plan yields tactical advantages which may well exceed the disadvantages of the doubt and confusion resulting from the absence of a detailed plan.

3. Technological Restructuring

3.1 Modernization with Leninist Characteristics

Since 1986, the Soviet Union has set out plans to undertake technological restructuring with the aim of modernizing Soviet industry to meet world standards. Restructuring is to take place within the framework of Party dominance and central strategic planning, a form of Lenin's concept of central control over the "commanding heights" of the economy. Traditionally, the concept has translated into direct central control over energy and heavy industry.[4] Now the concept is to be applied to macroeconomic planning, external economic relations, and decisionmaking in such strategic sectors as scientific and technological projects, defence, national communications, and transportation.

Technological restructuring is to increase factor productivity and the quality of outputs through high technology investment and the rationalization of inefficient sectors. As large-scale disinvestment can lead to decreased output in the short run, Soviet reformers have concentrated on the retooling of existing plants to recoup initial outlays rapidly, to achieve visible economic growth and to augment hard currency exports as quickly as possible.

Since modernization to world technological standards would be difficult to achieve without international trade and cooperation, Soviet policies now emphasize international interdependence and openness. This strategy appears to take as its model the transformation of the post-war Western industrial economies, where capital, technology, and management techniques have been transferred across national borders through multinational corporations and joint ventures. Arguably,

significant increases in the productivity of energy and agricultural resources, of manpower and of other inputs to production played an important role in the West European and Asian economic miracles. Soviet reformers have these same objectives. They seek to engineer a more efficient economy.

So far, restructuring has not met the expectations of Soviet reformers, nor has it encouraged optimism about the prospects for the ultimate success of perestroika. Indeed, according to Nikolai Ryzhkov, 1988 did not represent a step forward in technological reform. No significant progress was reported in energy or metal conservation or in the increase of labour productivity in industry, even though several hundred plants were closed for renovation. Furthermore, bottlenecks in renovation have reduced total capacity; in only sixty percent of the plants due for renovation in 1988 was renovation completed.[5]

Small but significant progress was made in reversing previous policies which subsidized unprofitable industries. Current shortfalls in the construction industry may, in fact, be ascribed to disinvestment resulting from that policy reversal. But political considerations have interfered with the commitment to cutting subsidies for failing enterprises from the state budget, and more generally to applying the concept of bankruptcy, crucial for the effective application of market forces. For example, none of the Soviet industrial monuments built in the 1920s and 1930s (e.g., the Magnetogorsk steel complex in the Urals) has been closed for renovation. Moreover, not all shortages may be attributed to the short-term effects of retooling industry. A recent report points out that "continued low growth might have been acceptable to the leadership if it had been caused mainly by enterprises halting production in order to retool ... instead, supply disruptions, failure to bring new capacity on line, and confusion generated by reform measures constrained output in most branches of industry."[6]

3.2 Systemic Changes Toward Modernization

Closing plants and renovating capacity lead necessarily to short-term interruptions of production. The resulting shortages can be relieved only by the installation and effective operation of new capacity. Indeed, Soviet reformers should expect that disinvestment will not only manifest itself in bankruptcies but also in large amounts of frictional unemployment. Hence social problems are likely to arise as workers are fearful of unemployment and the prospect of job mobility. A risk-averse viewpoint has developed among Soviet workers exposed to two generations of state indoctrination

regarding the evils of capitalism, with particular emphasis on unemployment and inflation.

Soviet reformers have been interested in applying lessons taught by Western experience with technological reform. Most countries share with the Soviet Union a concern to avoid frictional and structural unemployment. It has been found, however, that in countries where priority is given to full employment and job creation, workers tend to be less antagonistic to technological change; indeed, they are said to want the latest equipment, viewing it as a means of increasing profitability and, therefore, their own real incomes. Job-finding aid for displaced workers, bureaucrats and even managers, and the prompt reorganization of failing enterprises can mitigate economic dislocation and maximize the benefits of restructuring.

Sweden's labour-management policies exemplify this approach. In times of structural change, Swedish industries direct their attention to workers first. And the government helps to promote full employment during restructuring by providing an efficient employment service and a comprehensive human-resources development system (training, counselling, and rehabilitation), and by direct job creation aimed in particular at the least productive elements of the labour force. Income maintenance is viewed as a last resort. The Swedish experience is being studied with interest in the United States, as well as in the Soviet Union.

In the United States, the restructuring and modernization of bankrupt enterprises often takes place through the activities of venture capitalists. Failing firms are taken over by an outside group of investors who authorize changes in management, labour force, and work procedures, in an attempt to convert an unprofitable plant into a productive enterprise. In doing so, the venture capitalists utilize market prices to determine the optimal way of refinancing and modernizing the enterprise so that it may become competitive and attain profitability. This process effectively minimizes the adverse impact of unutilized capacity, both in the form of frictional unemployment and interrupted production. Venture capitalists, however, are an especially American institution. Soviet policymakers may want to study the Japanese development experience, in which competitive sectors were subsidized while direct and indirect measures were taken to restrict the activities of unproductive sectors.

4. Economic Reform

4.1 Decentralization of Management to the Enterprise

4.1.1 The Soviet Programme

Decentralization of management from the central bureaucracy to the firm is the primary objective set forth in the Decree on the State Enterprise, in effect since January 1, 1988. It is intended to give new rights and responsibilities to the enterprise directors and worker collectives. So far, laws provide directors and collectives with specific authority for self-management, including decisions on production, investment, contracting for supplies, and marketing. The use of compulsory output targets is to be reduced so that each enterprise may determine its own output mix based on profit maximization. Inter-enterprise trade is to take place on a contractual basis, with goods exchanged at prices agreed to by trading partners.

Enterprises will be responsible for drawing up output and delivery contracts as well as an overall delivery plan, fulfilment of which is to be used as the primary criterion for judging performance. Microeconomic efficiency is to be improved by allowing entrepreneurs to retain profits for compensation and capital accumulation. Enterprises are to be fully self-financing; they must operate within a hard budget constraint to remain in business. The rights and responsibilities of cooperatives are even more explicit, while worker collectives are to share responsibility for incomes policy and conditions of work.

The purpose of decentralizing management is to increase initiative and responsibility at the enterprise level and thereby augment the quality

and quantity of goods produced. Reform-minded leaders hope that directors and workers will accept the responsibilities conferred by self-management and economic accountability—encouraging the introduction of new technology, welcoming unequal pay based on productivity and adopting quality control measures. They hope that the new opportunities for innovation and profit-making will offset the potentially negative social and economic consequences of market-oriented reform.

Likewise, Soviet policymakers hope that by enforcing full economic accounting, they will make firms cost and quality conscious in striving to maximize long-run profit. As firms become cost minimizers, they are expected to seek out wholesale markets, rather than relying on traditional state orders. As cost minimizers, moreover, enterprises should reduce orders for excess inputs. Initial, concrete steps to reduce reliance on state orders may accelerate the development of wholesale markets. In addition, markets must be made competitive to ensure that enterprise profits do not accrue to monopolistic state-owned enterprises, but arise from the competitive use of resources and the quality of production. Soviet reformers appear to have taken a positive step in this direction by setting up cooperatives in the agricultural sector to provide a competitive yardstick for some state enterprises. In addition, proposals are currently being considered to split up large combines—a form of trust-busting to foster competition.

To date, the shift of management to individual enterprises has been very modest. The new environment outlined in the Decree on State Enterprises was to create conditions which would encourage improvements in the quality and quantity of goods produced, but this has not occurred. Indeed, a not insignificant group of managers and work collectives appear to be fearful of giving up the perceived security of the old system, which guaranteed markets by state order and established full employment artificially, and they may resist reform. To function in the new system will involve them in risk taking in an environment already characterized by confusion and uncertainty. In fact, they view a system which permits bankruptcy and unemployment as inherently bad, even though it provides a greater potential for profit making.

Some Soviet reformers believe that more specific legislation may be needed to assure the effective devolution of rights and responsibilities from the central bureaucracy to the enterprise. Leonid Abalkin, for example, believes that the newly established management responsibilities and rights must be further redefined in the industrial sector in order to

implement the shift from the central bureaucracy to the individual firm. He argues that enterprise rights must be safeguarded to ensure the actual implementation of decentralization.[8] Nikolai Shmelev has put forth a proposal that goes beyond those of the Party Plenum of March 1989. He calls for a complete end to the system of obligatory deliveries in the agricultural sector and the transfer to the local family unit of responsibilities for most decisions. If adopted, this decollectivization would change the basic character of the agricultural system.[9]

4.1.2 Considerations for Future Policymaking

The more radical reformers appear to perceive more clearly than others that inherent conflicts exist in any reform and particularly during a transition from longstanding centralized management to microeconomic decentralization. In order for decentralization to move forward, reformers must address the basic dilemma facing enterprise managers: what means may managers use to address grievances against the very authorities whose decisions continue to determine the enterprise's resource allocations, the prices of its inputs, and ultimately its profit margin? Those managers who follow the tenets of self-financing and full economic accounting face a fundamental problem, because profitability is still based on input and output prices established by apparatchiks in ministries, and is thus more likely to depend on an organization's luck than on the value of its output to society. Given the arbitrary nature of prices, the Soviet authorities must design carefully the criteria for measuring accountability and the consequences for failure (bankruptcy) if they expect managers to be risk-takers. In Western countries, managers are considered to be valuable resources. When a firm goes bankrupt, a manager may temporarily lose his or her job but has valuable knowledge and often finds comparable employment elsewhere.

While self-financing and enforcement of a hard budget constraint will foster the shift by Soviet enterprises from output to profit maximization, reformers should differentiate between typical profit-maximizing firms and firms which may run deficits but produce positive externalities. Research and educational institutions are not usually profit maximizers but add to the overall productivity of the future Soviet economy. Environmental protection produces positive externalities and therefore may require certain forms of subsidization by the state. Finally, it may be necessary to subsidize certain goods and services that are needed but not produced due to the inherent uniqueness or the unprofitability of

production. Countries in the West also engage in these forms of subsidization.

In reforming the management system, Soviet reformers may also wish to consider the advantages of reducing the vertical hierarchy and expanding horizontal integration at the enterprise level. Several Western experiences might be interesting here. Sweden, for example, has developed a plant-management strategy that has increased productivity and reduced costs.[10] Central features include direct access of managers to top policymakers, the creation of a "flat decision structure," and direct participation of workers in decisionmaking. In a new Volvo plant, only 100 people oversee 73,000 employees organized in 400 units. Another example of effective plant-management strategy drawn from U.S. experience, is the case of Harley-Davidson, which had dominated the motorcycle market for many years but was unprepared to deal with stiff international competition. It sought trade protection from external competitors while it upgraded obsolete technology. It also sought to increase worker participation, involvement, and training, believing that "you cannot inspect quality in, you build quality in."

In the agricultural sector, smaller, more autonomous units in the form of private farms have typically been more productive than larger, less autonomous units. Western studies involving East-East and East-West comparisons of quantity and quality indicate that the structure and management of the producing unit is a critical factor in performance. In fact, comparisons between the Federal Republic of Germany and the German Democratic Republic—where cultural traits, it may be argued, can be held constant—show that the smaller units of production and decentralized management typical of West Germany are significantly more productive than the larger, collective farms typical of East Germany. Similarly, individual Polish farmers typically produce more for the market than do their counterparts on collectivized Byelorussian farms.[11]

4.2 Reduction of the Central Economic Bureaucracy

4.2.1 The Soviet Programme

Several reforms have been introduced to eliminate centralized microeconomic management by ministries and state committees. Rather than overseeing the routine operations of enterprises, ministries are to focus on long-term planning and strategic decisionmaking with regard to such matters as investment and technology policy. Since microeconomic

decisions are to be decentralized, Soviet reformers have argued that the number of centralized decisions will be reduced and the central bureaucracy should therefore be reduced. Redundant bureaucrats are to be shifted to the productive labour force, and those who remain in the ministries will be held accountable for final results.

Although the process of ending centralized micro-management is now said to be underway, reformers have attempted to weaken the vertical links between ministries and enterprises by removing approximately one-third of the bureaucracy.[12] Yet the vertical links remain strong, and the horizontal integration of sectors or large units has not proceeded very far. A comprehensive reform of the ministerial system, expected but not yet underway, may focus on defining more clearly the 'guidance role' of central bodies as well as outlining mechanisms for shifting decisionmaking authority to individual units (enterprises, cooperatives, family farms, etc.). Presently, the Institute of Economics is said to be in charge of planning these changes, to be embodied in a law on Ministerial Reorganization.

4.2.2 Considerations for Future Policymaking: Reintegrating Displaced Workers

To date, the central bureaucracy, which serves as both the main administrator and allocator of resources to enterprises, has been singled out for criticism and complete overhaul. If its powers are reduced, however, but bureaucrats are held more closely accountable for economic events over which they will have less control, perestroika may be undermined by bureaucrats attempting to protect themselves. Furthermore, in planning organizational changes, reformers should remember that the bureaucrats' status and perquisites have been based on the size of their turf. A reorganization of ministries into super-ministries may reduce ministerial autarky. At the same time, however, it may be viewed as a threat to bureaucrats in existing ministries who will stand to lose status and perks. Without hope of regaining both status and perks in different jobs, bureaucrats are likely to sabotage new structures, even if super-ministries are more efficient.

Methods of providing job security and incentives should be devised to accompany the rationalization of the central economic bureaucracy in order to reduce bureaucratic resistance to reforms as well as to prevent losses of labour resources. The provision of new job opportunities may reduce bureaucratic resistance, but the effectiveness of such efforts would

be significantly reduced if bureaucrats continued to face the prospect of forced retirement or loss of residence rights in major cities. A professional placement programme should be developed to provide opportunities for maintaining income, housing, and other perquisites while reassigning personnel to productive employment in enterprise management. Professional and vocational retraining programmes widely used in the Federal Republic of Germany have generated Soviet interest and may provide useful models. Safety nets that merely provide transitional income or delay reductions in force have not been as successful in Western experience as programmes emphasizing job placement and retraining. Exchanges and joint ventures with Western business and management schools that are currently being explored may also provide professional retraining. Likewise, training related to joint ventures in banking, manufacturing, and other productive activities might prove valuable in creating a new type of Soviet white collar professional.

4.3 Enhanced Central Leadership Role in Strategic and Guidance Planning

The top-down process of reform in the Soviet Union has made the Communist Party and Soviet Government vital in designing systemic reform and in strategic planning for the economy. The power vested in the top Party leadership and the staffs of the Secretariat and the Politburo have been strengthened to help them lead the Soviet Union through the turbulent times that are characteristic of reform. This consolidation is, in part, a response to the belief that many reform proposals made during the Brezhnev period failed because of ineffective oversight and leadership at the top.[13] Gorbachev's personal involvement in policies concerning economic reform represents the most direct commitment to economic policy and planning by any Soviet leader since Lenin.

Public statements by Gorbachev also highlight the top-down Soviet mode of reform. Speaking in Belgrade in March 1988, he noted that a major difference between the Soviet and Yugoslav economies is the strong leadership role of the central Party and the government in Soviet decisionmaking. The preparation of new decrees, directives, and laws by commissions, committees, and departments in the top organs of the Party and government give substance to the Party's new economic role. Soviet reformers have also encouraged national debates on policy to promote support for their policies.

4.4 Changing the Economic Management Role of the Regional Party

4.4.1 The Soviet Programme

In the wake of the June 1988 Party Conference, Soviet leaders hope to expand the rights of regional governments and agencies in economic affairs, while limiting the Party role to political affairs. The election of a new Chamber of Deputies in March 1989 strengthens the government and popular voice at the top.[14] The major agenda set forth for the Party Conference calls not only for democratization but also for reduction in the Party's role in economic management (e.g. by reducing direct orders from Party to economic units and increasing the role of the local Soviets).

4.4.2 Considerations for Policymaking

Redefining the local Party and Soviet roles in the day-to-day functioning of the enterprises may be appropriate for a modern economy making the transition from extensive to intensive development. Just as Lenin gave weight to the roles of experts as contrasted with "reds" in the New Economic Policy period, so the separation of the roles of technical managers and political activists of the Party may be in order now.[15] Yet Soviet managers are likely to encounter some political oversight as the leadership attempts to maintain a certain level of social equity and ensure the effective operation of market forces. Furthermore, the devolution of power from the central bureaucracy to the regional and local levels, while meant to increase managerial flexibility and impose accountability on enterprises, may only increase petty tutelage, particularly in the absence of full economic decentralization and of strong legal protection for enterprise rights. Hence, legal protection for the autonomous rights of enterprise directors and work collectives is crucial for the success of reform.

Broad legal protection, if properly implemented and upheld, could bolster the newly empowered decisionmakers and institutions and give a more solid foundation to the concepts of self-management. Experimentation with worker self-management may in turn reinforce critical traits, including the ability to speak up, to exercise responsibility and take initiative, and eventually, even to engage in entrepreneurship. In addition, the regulation of cooperatives may serve as an example for enterprise managers regarding the rights and responsibilities of self-management.

While regional Party units must therefore be willing to give up what

was in the past a major source of power, they may gain new roles in implementing the central reform policies and encouraging new economic forms such as producer cooperatives. New political and social functions for the local Party in furthering perestroika might help to redirect the Party's activities away from economic intervention. Furthermore, the Party could encourage more open discussion to facilitate a broader expression of democratic centralism and more participation by workers, peasants, and citizens in the production process. If local officials define the Party's role as a catalyst for political and social change, they may take the lead in developing innovative systems for mobilizing resources for cooperatives in the city and the countryside.

Parallels may be drawn between current changes in the role of the Soviet Communist Party and changes in the roles of Western sovereigns in the 18th and 19th centuries as their countries made the transition to market economies. The powers of the monarchs were restricted to allow market forces to operate more effectively. Adam Smith's "invisible hand" was to regulate the market, allocating land, labour, and capital to its most efficient uses. Governments were said to derive their legitimacy from the Lockean social contract and were to provide a healthy environment for business. Later, that environment was defined to include a sound infrastructure (national transportation, electricity, and energy systems) and regulation to ensure proper competition. Over time, the government's role expanded to include the regulation of workplace conditions and the environmental impact of production. In the early 1980s, there was a shift to market forces from government decisionmaking and a process of deregulation and privatization.

Currently, deregulation and privatization have raised questions on the proper balance between market forces and government intervention, especially in the United States and United Kingdom. As one former Chairman of the U.S. Council of Economic Advisers, Arthur Okun, put it, "the market needs a place and the market needs to be kept in its place."[16] Managing the tension between markets and governments in innovative ways, to fit an ever-changing constellation of issues, is an ongoing process. In the Soviet Union, the balance between central planning and market forces and between Party control and democratization will continue to be controversial, difficult to maintain and, as in the West, must be managed as a continuing process of discovery and change.

4.5 Monetization of the Soviet Economy

4.5.1 The Soviet Programme

Price reform, scheduled to begin in the early 1990s, is a process whereby prices that were formerly set administratively will be allowed to float freely, determined by the market forces of supply and demand. The implications are far-reaching: the freeing of consumer and wholesale prices would essentially create a market-oriented, decentralized economy. Specifically, implementation of price reform would lay the foundation for guidance planning, economic decisionmaking based on objective criteria (e.g. efficiency, rates of return, and comparative advantage), the application of competitive performance standards and mechanisms for accountability, a freely convertible currency, and a rational tariff structure. Yet price reform presents policymakers with an inherent dilemma. While it is an absolute precondition for monetization and decentralization of the economy, it carries with it high short-term costs. Undertaking price reform in an economy like the Soviet Union, with excess demand and heavily subsidized consumer sectors, the leadership faces the potential for unbridled inflation and its negative social consequences. Questions of equity, particularly for workers on regular salaries whose living standard will fall rapidly as consumer prices increase, raise doubts about the best way to proceed with consumer price reform; and these have delayed price reform until after 1991.

Dealing with the excess purchasing power in the system—the so-called monetary overhang—is a first-order problem for Soviet policymakers. The Minister of Finance, Boris Gostev, proposed the following strategy for dealing with the acknowledged 100 billion[17] ruble overhang:[18]

- Discipline the economic mechanism by tying wages to productivity and requiring enterprises to end deficits—wages rose last year by 12%, productivity by 5%; one out of ten enterprises were in deficit. The hard budget constraint is a part of enterprise reform, restricting loans to failing enterprises.
- Increase revenues by placing additional taxes on incomes and profits, especially the "unearned incomes" of some cooperatives. Sharply reduce capital investment and cut defence spending by 14 percent.
- Absorb purchasing power by a 12 billion ruble increase in domestic production of consumer goods, including some imports, and reduce supplies to non-market consumers (a euphemism for cutting special

privileged channels to Party and government bureaucracy).

- Increase savings and personal investments through sale of housing and property claims on farms, enterprises and cooperatives.

Shmelev, who estimates a much larger overhang, argued for reversing the restrictions on alcohol production, supporting a heavy tax on liquor sales in order to encourage abstinence, and the use of foreign credit to import up to $15 billion of consumer goods in one year and $3.5 billion on a continuing basis. The shift back to government sale of alcohol may generate up to a 15 billion rubles of additional tax revenue, reducing the 76 billion ruble budget deficit by about one-fifth in 1989.[19]

4.5.2 Considerations for Future Policymaking: The Inflation/ Intervention Cycle

Shifting to market forces in management and incomes policy is a daunting task in any centrally planned economy.[20] Proceeding directly to consumer price reform, say in 1991, would have high short-term economic and political costs. Perhaps the most critical initial requirement is to manage demand by bringing the money supply into line with the supply of goods and services. While all elements of fiscal policy must be employed to reduce the monetary overhang, improvement in the quality of goods supplied, together with rising real incomes for productive workers, may allow for an increase in prices without imposing severe austerity.

Creating new cooperatives in the service sector to absorb labour released by increases in productivity may also provide significant short-term improvements in the quality of life. The growing attention given to cooperatives suggests their important role as a source of job creation. Thus, hundreds of thousands of cooperatives formed in 1987-1988 have provided more products and services for the population and a new source of productive employment. Unfortunately, perceptions that cooperative activities have led to "unearned" price increases (despite improved services and goods) led to the introduction of sharp control over the activities and profits of cooperatives in December 1988.

Intervention by the centre is both likely and damaging. As prices move to their equilibrium levels, bureaucrats will want to recentralize to establish "order" in markets. This type of intervention would represent a major setback to progress in reform; for as long as members of the old bureaucracy, trained in the thinking and decisionmaking associated with central planning, continue to intervene, local decisionmakers may continue to base their own decisions on the interests of the bureaucrats

rather than market forces. In addition, private producers, without the benefits of being inside the old system, may find it very difficult to compete on an uneven playing field. Eventually reform will suffer at its root—the functioning of the enterprise. Step-by-step approaches may be critical to minimize the highly negative social consequences of price reform and avoid the inflation-intervention cycle. The transition toward reliance on market forces could take place through the use of short and medium-term strategies.

4.5.3 A Short-Term Strategy

In the short-term, large price changes might merely result in overt or concealed inflation, and other measures may have to be taken to increase supply, dampen wage-price pressures, and cushion the impact of reductions in income caused by increases in sensitive prices such as meat and rent. Effective incentive systems may turn on an increased availability of hard goods such as quality food products, home appliances, and services. Constraints on output in agriculture may be less of an obstacle to improving food supplies than defects in the harvesting and transportation infrastructure that moves the crop from field to table. Direct attention to losses in quality and volume in harvesting and transport may lead to improvements where it counts—on the consumer's table.[21]

Several specific proposals for managing the current monetary overhang deserve consideration. Creating a central bank that can act independently of prevailing political pressures and therefore move most effectively against inflationary pressures by pursuing a tight monetary policy. Initiating a comprehensive programme to increase revenue and absorb purchasing power by allowing the sale of bonds, long-term leases, and consumer services, as well as taxing excess profits and luxury goods. Likewise, a centrally controlled incomes policy that ties wages to productivity might play a major part in a comprehensive programme for financial and monetary discipline.

4.5.4 A Medium-Term Approach

Over the medium term, there might be a transitional phase during which a simulated market is created. Price ranges could be specified which would represent a move in the direction of a rational price structure, but would also meet the political and equity concerns of the leadership. Movements of producer and consumer prices toward market-clearing levels would provide useful price signals to management and would

restrict the role of the second economy. For example, both housing and meat are heavily subsidized. During the transitional period, higher price ranges could be set for housing and food products, and these would be raised until prices stabilize at market-clearing levels. The point is to move by steps in the direction of a rational price structure.

During the transitional period, before a fully rational structure is established and objective criteria for policymaking set forth, problems of inefficiency, corruption, and inflation are likely to persist. These negative aspects of a staged approach may be mitigated, however, by a strong emphasis on increasing supply, through growth in both social and private production. These steps would both combat the worst aspects of inflation and broaden the influence of the market in order to weaken the control of central bureaucratic managers. While Western economists agree that only through comprehensive price reform can other aspects of perestroika succeed, political economists might be more inclined to favour the transitional approach, taking into account the short-term politico-economic benefits of maintaining a staged approach.

Other countries share with Soviet leaders the desire to avert the negative social consequences of inflationary pressure. Soviet efforts to produce rising real incomes by raising agricultural production at the start of the transition may benefit from Western experience in managing the farm-to-market system and the service industries. Development of cooperatives, coupled with investment in the farm-to-market infrastructure to facilitate marketing by cooperatives and family units as well as by state and collective farms, would raise real incomes. The United States and Western Europe have had long experience with agricultural cooperatives, as Lenin himself was aware when he wrote his famous article on cooperatives, cited in the 70th anniversary speech of General Secretary Gorbachev. Western techniques for food storage, transportation, and the processing of perishable products and Western marketing techniques are especially relevant for Soviet economists and businessmen.

Analysis of the successful management of inflation by the Federal Republic of Germany in the 1950s, and by Italy, Japan and South Korea at later dates in their development may provide useful insights, but the lessons may have limited relevance. Although monetary reforms involving the issuance of a new currency or of dual currencies have their advantages, they may not fit the Soviet political and economic environment.

4.6 Towards Interdependent External Economic Relations

4.5.1 The Soviet Programme

Interdependence entails the establishment of an effective interrelationship between domestic and foreign markets whereby external economic relations are based on comparative advantage rather than ideology. Gorbachev's conception of interdependence appears to go far beyond the strictly economic; it bears on arms control, environmental protection, and over-population—the whole range of interactions in the world today.[22] Interdependence has several key aspects, including the establishment of joint ventures with Western partners; fostering bilateral relations with governments to supplement the private economic network; and gaining acceptance as a full member of the international economic system.

Since 1986, the Soviet leadership has been actively engaged in developing fruitful commercial relations with the West. With the ultimate goal of becoming a competitor in the world economy, it is actively seeking to increase trade through joint ventures that will bring Western management and technology into the Soviet economy. The importance attached to trade with the West is exemplified by recent changes in Soviet joint venture and foreign trade laws, which have been made much less restrictive. Gorbachev has attempted to show the logic of the link between Soviet globalism and interdependence, on the one hand, and the transfer of technology through joint ventures, on the other.

At present, certain priority domestic sectors appear to be a central focus for joint ventures. In the short term, Soviet reformers have focused on providing hard goods as bonuses to Ivan Ivanovich, so that, as he begins to work, he will begin to receive material benefits not previously available—better food, housing, and medical care. Energy technology has also been an area of intense interest, because it has become essential to foster domestic conservation and increase energy export capability. Over the longer term, the Soviet Union appears to favour joint ventures which hold the best chance of increasing Soviet exports of manufactured goods.

So far, the reform of foreign economic relations seems to be proceeding on two levels. One involves major multinational entities organized from the top-down and keyed to priority Soviet sectors and to major lines of tied credit. The other and much more limited type (involving perhaps 10 percent of trade) involves individual enterprises and is based

on principles of self-financing. Apparently, this second type of trade will serve as a laboratory for developing openness. To date, over 300 Soviet-Western joint ventures have been established, ranging from one building offices for Western businessmen in Moscow to one producing tampons.[23] Nevertheless, questions about adequate quality control, sufficient and timely supplies of necessary materials and labour, taxation, and the valuation of Western contributions still arise in Western-Soviet discussions. Moreover, as the number of joint ventures increases, current restrictions on credit facilities will pose increasingly severe barriers to the expansion of bilateral trade.[24]

4.6.2 Considerations for Future Policymaking

To be a competitive economy, an industrial nation must be open to the best and cheapest products regardless of origin. In a technologically changing world, the opportunity costs of autarky are increasing. If perestroika is to be fully successful, the Soviet leadership must accept interdependence with the advanced industrial economies, including joint ventures, bilateral governmental exchanges, and broad participation in the international economic system.[25] It can even be argued that the reformers must harness domestic reform to the external economy, dragging the Soviet Union up to global competitive and regulatory standards.

At this stage, given the inconvertibility of the ruble, joint ventures may be the best way to realize relatively quick results. Joint ventures would thus be most relevant to Soviet economic needs if they provided *systems* improvement, e.g. in bringing food from field to table, energy from well or mine to pump or boiler, and in the machinery chain from metal forming to manufactures for world market. Initiation of close, extensive cooperative relations is now necessary if Soviet firms are to gain a share of a highly competitive global market for manufactures in the 1990s.[26] Until the Soviet Union undertakes price reform and establishes a rational exchange rate, optimizing foreign economic relations on the basis of comparative advantage will be a slow, imprecise, and difficult task, further complicated by the need to bring the Soviet economy up to the standards of international markets. Ultimately, the test of industrial joint ventures is the future ability of Soviet enterprises to sell cars, machinery, and other manufactured goods competitively. For a Western partner, the test of a joint venture's viability would be whether the expected profit in hard currency can exceed that from alternative investments elsewhere.

A number of specific developments could contribute to increased commercial interaction. For example, companies contemplating major investments might look to the example of the American Trade Consortium. In an innovative effort to overcome past problems in developing significant, long-term commercial relations, two trade consortia have been formed, led on the U.S. side by a group of major corporations and on the Soviet side by the chairman of the State Commission on Foreign Economic Relations and senior officials of Soviet ministries and enterprises involved in foreign trade and finance.[27] The Soviet State Commission on Foreign Economic Relations presumably will arrange coordination of supplies and funding and assist in overcoming problems. The two consortia negotiated an umbrella "trade agreement" as a framework within which each company's own joint venture agreements will operate.[28] In particular, the consortium may provide a means of dealing with the Soviet requirement that joint ventures must earn hard currency if foreign companies are to repatriate profits in dollars. If the consortium as a whole earns hard currency, the Soviet leadership has guaranteed that profits earned and converted into dollars may be repatriated.

Nevertheless, ad hoc joint venture agreements, even if arranged through consortia on especially favourable terms, are not likely to create a trading relationship conducive to significant Soviet benefit and to Western profits. Qualitative changes are needed on the Soviet side. These might include:

- *A key import strategy* that reflects the current emphasis on food processing, medical supplies and equipment, and housing, but has a long-term focus on imports that improve efficiency in material output (the energy chain) and provides entry into the world machinery market (e.g. automobiles).
- *A flexible balance of payments policy* using all the techniques employed by newly industrializing countries. Specifically, the Soviet Union would need to run current-account deficits in the short run in order to shift its production-possibilities curve to a higher plane. Investment in modernization of the economy will result in higher productivity and competitive goods in the future, which may then be exported to reduce the debts incurred in order to finance the earlier current-account deficits.
- *An end to economic espionage* and illegal acquisition of Western technology. The Soviet Union must subscribe to international

agreements covering trade protection and intellectual property rights.

- *The establishment of foreign commerce zones*, whether sectoral or regional, to foster the rapid development of a new export-import culture.
- *A transition toward eventual convertibility of the ruble* as the basis for establishing a realistic exchange rate and a tariff system conforming to international standards. This will become increasingly important for the Soviet Union's future export strategy; without a convertible currency, even the expansion of joint ventures may be curtailed due to the inability of Western firms to repatriate profits.

What might these developments imply for future Soviet trade with the West? Certainly, as the Soviet Union undertakes further reform and takes steps to make the Soviet Union a less hostile commercial environment, Western partners will increasingly be pressured to re-assess commercial relations regarding the necessity for a Western response and the role of the Soviet Union in the global economy.[29] Some believe that prospective changes in the superpowers' positions will lead to a moderation in the cycles that have characterized U.S.-Soviet trade relations, so that they will match the more predictable, stable course of their allies' East-West commercial relations. With the emergence of an integrated European Community in 1992, a continuation of restrictive U.S. policies may not effectively restrict other Western countries' commerce with the U.S.S.R. It would probably dampen the expansion of East-West trade but at the potentially high cost of alliance tensions. If the U.S. moved closer to the policies of its allies, by contrast, a major source of recurrent friction within the Western alliance would be removed, and the benefits of consensus on commercial issues may be of increasing value given current alliance tensions regarding defence policy.

4.6.3 Participation in International Organizations

Participants in the Bretton Woods Conference envisaged membership of all nations in an open, stable, universal, and growing trading community. Many years have passed since the U.S. and U.S.S.R. went separate ways on this issue. Now, the Soviet Union has adopted a policy of increased interdependence and promotion of exports to the West and has expressed interest in participating in international economic organizations such as the GATT, IMF, and World Bank. In fact, the Soviet Union has already applied for observer status at GATT.

The broad question facing the Soviet Union in attempting to join the international economic system is whether the cost in institutional change

is worth the benefits to be obtained through interdependence and the advancement of perestroika. Many specific issues on the GATT agenda would presumably be of interest to the Soviet Union: normalized commercial relations in terms of tariff and non-tariff treatment, application of the rules on subsidies and dumping, sectoral policies on agricultural trade, and the treatment of trade in services. Yet GATT is a beleaguered organization even in the West and may not be able to offer the trading environment which the Soviet Union seeks through membership. In international finance, the roles and policy of the IMF and World Bank, as well as the regional banks, such as the Asian Development Bank might be viewed as being of increasing relevance by the U.S.S.R.[30]

The broad question facing the Western nations, including the United States, involves the balancing of net returns from mutually beneficial commerce and international economic cooperation against the political and security risk that may be posed by a modernizing Soviet state with a voice in the policymaking of international economic institutions. A period of discussion and planning for entrance may be both useful and necessary. On the one hand, an argument may be made for opening discussion with the Soviet Union about its future role in international economic organizations. Jozef M. van Brabant offers several reasons for conducting such a dialogue:

- The world trading system was originally conceived as a global one. Serious efforts were initially undertaken to accommodate economies that are not anchored to market-type instruments and institutions.
- The Soviet Union did not seek participation in the debates about this system from about mid-1946, but largely for political reasons.
- The legal framework of the GATT is not well suited to accommodating countries that are not organized along the basic foundations of advanced market economies. Moreover, since the early 1970s, although conflicts in global trade have multiplied, the GATT has not been able to resolve them or even to provide an adequate forum for negotiation. In addition, past experience shows that while the Soviet Union and its allies could be accommodated into the GATT rules on an *ad hoc* basis, this is not a desirable course.
- Ongoing reforms in the Soviet Union and in Eastern Europe provide a unique occasion for reassessing the basis upon which these countries could be incorporated into the world trading system as a group.[31]

On the other hand, the Soviet Union remains an adversarial superpower with a large economy and would carry more weight as a member in

Western economic organizations than any other new entrant since formation of those organizations. The Western industrial nations might benefit from the Soviet Union's interest in joining and participating but only if appropriate conditions for membership are applied. For example, the provision of accurate and adequate economic data and a credible prospect of movement toward currency convertibility might be among the preliminary conditions for joining the IMF.[32] The movement toward convertibility might take the better part of a decade, suggesting an appropriate time frame for the transition to membership. Western governments might also require specific assurances that the Soviet Union will not seek to politicize debt issues or undermine the rationale for economic readjustment promoted by the IMF or World Bank.

5. The Political Economy in Transition

Mikhail Gorbachev came to the forefront of Soviet power in March 1985 as a reform candidate. Broad recognition that the Communist Party and the Soviet Union itself faced stagnation and decline economically, technologically, socially, and politically compelled members of the Politburo to support him. The conservative Brezhnevites could offer no new directions and had thus to accept a moderate reformer ready to fight social decay, raise productivity and intensify modernization. No blueprint or model for reform existed. Effective East European and Chinese reforms provided a database on which Soviet reformers could draw. East German experience, in particular, centrally planned yet highly efficient, was hailed as a model for the Soviet Union. As reform gained momentum and the systemic nature of the pre-crisis situation was understood by Soviet leaders, Gorbachev and other like-minded reformers redefined the nature and scope of reform.

At the Central Committee Plenum of June 1987 and the 19th Party Conference of June 1988, Soviet reformers proposed substantive economic reform, including complete financial autonomy for enterprises, sharp reductions in the functions of central planners and administrators, and the greater reliance on wage and price differentials as indicators of performance and the basis for incentives. The agenda was broadened to include political reform in an attempt to break up the anti-reform forces in the central bureaucracy and Party. Finally, glasnost was introduced, bringing to light past errors, providing a vent for present frustrations, and furnishing momentum for continued change.

While the strategy for systemic change has been promulgated and

tactical initiatives have been taken to promote economic reform, implementation has lagged badly. The ministerial bureaucracy and central planning organs have resisted and subverted the reforms, even when those reforms have gone far to ensure the maintenance of central bureaucratic influence, albeit in different forms. Intellectual constraints and ideological resistance have also obstructed reforms. Half-hearted implementation, outright resistance at the top by a small but influential minority, and widespread confusion at lower levels have produced unsatisfactory economic results. Tangible economic benefits have been minimal, and some believe that living standards have actually fallen.

Against this background, perestroika has increasingly come under attack. Conservatives may not have a viable programme to address the crisis, but support for their objections to perestroika has grown in the wake of poor economic performance and rising ethnic tension. The radical reformers, in their turn, argue that changes are too slow and not thorough-going enough. The timing and interrelationships of the various components of reform have therefore become crucial. Several controversial issues have arisen, illustrating the short-term dilemmas that face Soviet reformers as the transition proceeds. Attitudes towards these issues give us insight into the direction of reform, the success of the Soviet leadership in solving them, and the long-term direction and prospects for reform. These issues are outlined below as follows:

5.1 Central Control and Democratic Decentralization

The institutionalization of democratic centralism was to strengthen the authority and legislative power of the reform leaders so that they could implement reform from the top down. The introduction of democratization and glasnost was to increase citizen participation. Does this combination hold promise of success or is it internally contradictory? Conservatives have challenged Gorbachev's rationale for glasnost and democratization, blaming it for ethnic tensions, excessive criticism of the Party, and movements for self-determination. At the same time, radical reformers outside the Party question whether reform has stalled because of equivocation by Gorbachev, charging that he has capitulated to the bureaucracy and the Party *nomenklatura* by centralizing power. Increasingly, the Supreme Soviet may become a decisive player in pushing reform beyond previously accepted Party limitations. A more mature electorate may develop a sense of responsibility and obligation commensurate with its democratic powers, and a new political culture

may develop.

5.2 Quantity versus Quality

Like past Soviet leaders, Gorbachev began by chiding workers for low productivity, exhorting them to stop drinking and start working. His goal was to increase output from the country's existing factories by speeding up production, much as East Germany had done. But Gorbachev found that more output of low-quality products boosted gross output figures but did not meet the needs of modernization. Like Khrushchev before him, Gorbachev began to criticize production for production's sake. Now he has shifted to intensification, emphasizing that the quality of output and the efficient use of inputs are the first measures of performance. So far, however, the shift in practice has been negligible. After 1988 plan performance failed to show qualitative improvement in production, Gorbachev complained that "Val" (gross output) is still king in the Soviet Union.

The new quality control organizations have not been able to act as true outside auditors. Quality control departments within the enterprise depend upon the enterprise manager for salaries and bonuses and are not likely to identify low-quality output. Instead of closing obsolete plants, terminating central orders, relieving central bureaucratic managers of their duties, and changing the statistical measures of the past, the Soviet leadership has opted for a more moderate transition to quality production by setting out quality standards and accepting only those goods that meet them. Yet, previous efforts of this type have failed for several reasons. Lacking alternative sources of supply, customers fear spoiling relations with reliable suppliers even when they fail to meet standards. Although reformers have acted to bolster the powers of the State Certifying Commission, it does not use them assiduously because of the implications for ministries and enterprises; when goods are rejected, supply plans cannot be fulfilled, bonuses cannot be paid, and ministry plan fulfillment is threatened.

Because qualitative improvement has lagged and the lowest-quality goods have not been sold, shortages have begun to build up. These may get worse in the short run as the Soviet leadership continues to push for quality and technological restructuring.

5.3 Industry or Farming and Services

In 1986, reform efforts focused on improving the performance of basic industry. Minimal attention was given to reforming the agricultural and service sectors. Experiences in China, Hungary, and elsewhere have led many to reconsider this emphasis on industry in the early steps of the transition. Moreover, the realization by Soviet leaders that the restructuring of industry would lead first to shortages and only later to increased quality and quantity caused them to stress reform in sectors which could produce results quickly. Since mid-1987, there appears to have been a shift towards reforms in producing food, medical care, and housing, all of them important for proving to the average Soviet citizen that reform works and should be supported. The legalization of cooperatives has been a vehicle for the decollectivization of agriculture and services, and more resources have been allocated to consumption and the development of a better infrastructure.

Decollectivization and privatization have been set back, however, by resistance to change in the regional Party and central bureaucracies, as well as by scepticism among peasants and workers. A significant portion of the populace is hostile to unemployment and income differentiation. Thriving cooperatives have been closed, successful farms burned. Soviet leaders must strike a new balance between rewards for excellence on the job and the tenets of communist ideology. Breaking down the intellectual barriers to reform is crucial for the establishment of a self-reliant peasant class but is regarded as one of the most difficult reforms to carry out.

A shift to cooperatives and family farms, with the bulk of the good land under their management, a substantial improvement in agricultural and farm-to-table infrastructure, and soviet and local Party oversight to assure adequate supplies and market access could lead to substantial increases in productivity. The use of military builders to construct infrastructure and provide transport would be helpful. There should be a substantial differentiation of incomes and an increased availability of hard goods would make them meaningful. Finally, the fifty year leases for good land might be made transferable, to be passed on to heirs or sold, in order to raise the potential benefits from taking a stake in family farming.

5.4 Guns, Growth, or Butter

The defence burden came to public attention in 1988, with critical discussions of defence spending, the conversion of military-industrial plants, the need for the current military draft, and a wide public debate on

allocation issues. For the first time in Soviet planning history, the guns-versus-butter trade-off appears to be moving in favour of butter.[33] So far, several significant proposals have been advanced: (1) to commission new plant and equipment for modernizing industry and agriculture; (2) to delay the upgrading of tanks, aircraft, artillery; (3) to reduce the draft of 18 year olds for military service and thus allow more of them to pursue advanced education or become gainfully employed in the industrial or agricultural labour force.

Thus, the primacy of defence claims has been politically challenged and the burden of defence openly acknowledged. Yet an increase of investment for civilian restructuring at the expense of military programmes would place perestroika in conflict with traditional views about the requirements of military security. Khrushchev was the last Soviet leader to challenge the military budget, was widely opposed by the military, and was eventually removed from power. New military planning, however, may shift from offensive to defensive capabilities, which require smaller forces and fewer officers. A reduction in the foreign policy roles of military sales and aid may likewise reduce military production and claims on hardware inventories. Soviet reformers must prove the validity of reform to the average Soviet citizen without losing the military bureaucracy to reactionary forces.

5.5 Political Economy of Price Reform

Consumer goods are heavily subsidized, contributing importantly to the budget deficit, which stands at least at 11% of GNP. Yet a sudden increase in the prices of consumer goods would be socially divisive and politically costly. So far, the political leadership has prevailed over Soviet economists who argue that price reform should have been the first step in reform in spite of the high costs. Instead, a more staged transitional approach has been taken, whereby the inflationary gap and budget deficits are dealt with first. Specifically, the leadership plans to increase supplies of consumer goods to absorb excess purchasing power, to move toward a market system by reforming wholesale prices, and to defer the reform of consumer prices. Then, during the 1990s, sensitive consumer prices, including rents, may be tackled in a comprehensive consumer price reform. The ultimate target is prices reflecting costs of production, without subsidies or other distortions, responding flexibly to demand.

The leadership faces a dilemma in postponing price reform. The longer the delay, the higher the risk that comprehensive reform will get

stuck indefinitely; which has been the result in many reforming economies. More rapid change, however, could have a serious negative and possibly regressive impact on the real incomes of citizens. It is therefore important to make rapid progress in the monetary overhang, reforming wholesale price changes and removing producer subsidies, so that the reform of consumer prices can begin and be achieved at an acceptable cost to the consumer.

5.6 Interdependence or Modified Autarky

Many decisionmakers in the Soviet Union and the West are deeply sceptical of plans to open up the Soviet economy, because the efforts made in the 1970s failed to bring the economy up to global standards. The foreign economic policy of the Brezhnev period was costly and ineffective. Large oil windfalls due to escalating OPEC prices were spent to mask the inefficiencies of the Soviet economy, and importing goods to cover shortages. Adequate wheat was grown but lost between field and table at a far higher rate than in other wheat-producing countries. Soviet imports of wheat have been likened to a drug habit: the wheat makes people feel good but does nothing to address or correct the inefficiencies of the Soviet agricultural system which produced the shortages in the first place.

Present Soviet reformers acknowledge that foreign economic cooperation is not likely to be beneficial without successful domestic reform. Gorbachev qualified the notion that billions of dollars of loans should be used for imports by stressing the need for foreign equipment and investment to complement reform in domestic sectors. The Soviet leadership view joint ventures as a vehicle for establishing mutually beneficial trade relations. The debate is presently focused on establishing special priorities for key foreign contracts with arrangements to assure Western participants of profitability and to facilitate crucial learning on the Soviet side. The aim is to establish enterprises in which the incentives for foreign and domestic participants are linked to domestic prices in an integrated market.[34]

The American Trade Consortium represents an example that might be emulated with other trading partners. Soviet leaders and Western businessmen may look to the four aspects of that deal as potential standards for major joint ventures with Japanese, South Korean, West German, Italian, British and French partners:

- In a concessionary natural-resource development, one of the partners will provide incremental oil output which the Soviet Union can export to

finance the foreign-currency needs of the other joint ventures.

- Efforts keyed to raising the production of food, consumer goods, and health services will bolster the overall reform effort.
- Western partners will have control of all elements affecting the effectiveness of technology transfer and the quality of output.
- Repatriation of profits from sales in the Soviet domestic market will make profitability meaningful and justify direct investment.

6. The Calculus of Success

A leading Soviet reformer, Tatiana Zaslavskaya, created Chart 1 to illustrate the range of support and opposition to perestroika. In many ways, it also highlights the "tightrope" which Gorbachev must walk in attempting to maintain and cultivate support without weakening his position vis-à-vis a substantial reactionary group.[35]

Social groups supporting or opposing perestroika are influenced by the effects of reform on their authority, incomes, and privileges. But the chart may be likened to a snapshot of a moving target. A purge of the party and governmental bureaucracy may transform opponents with great influence into average citizens or retirees. More food, better medical care, housing and environmental improvements may influence people to support perestroika, especially if democratization and glasnost provide freedom and civil rights not formerly assured. The purging of political conservatives and provision of political benefits to Soviet citizens have proceeded faster than improvements in material benefits. The political break-even points for Gorbachev and for perestroika itself cannot be known in advance.

So far, Gorbachev's course seems to be based on a reasonable assessment of the need for change and a sensible strategy for implementing perestroika. He has woven a path between conservative detractors on the one hand, and vocal left-wing outsiders and ethnic nationalists on the other, to continue reform. The most radical reformers want to increase popular power; to purge the Party and central bureaucracy; to weaken central authority; and to implement price reform more rapidly. Conservatives stress more gradual change in personnel and

institutions, less glasnost, and less pluralism in Party and government roles. Their approach may satisfy more power holders and appeal to some elements of popular conservatism, but it does not offer promise of long-term economic growth or international competitiveness.[36] Thus, while the reformers have captured the moment with a concept for a better Soviet future, a backlash by conservatives remains a possibility. Economic reform initiatives may be particularly vulnerable to being undermined, given that the traditional reaction of Soviet economic bureaucrats when faced with bottlenecks or queues is to intervene by reasserting central control.

With these caveats in mind, many longtime Soviet analysts in the West look to the Soviet Union to provide a precise plan for dealing with the recognized problems of transition and thus with the internal pressures to

Chart 1

Typical Positions of Soviet Citizens Towards Perestroika:
A Diagrammatic Representation of Various Strata and Groups in the Soviet Union

Social Strata and Groups	Position Towards Perestroika							
	Initiators	Advocates	Allies	Quasi-Advocates	Observers	Neutralists	Conservatives	Reactionaries
Leading Industrial and Collective Farm Workers								
Political and Economic Managers								
Intellectuals in the Social Sciences and Humanities								
Small Business								
Majority of Industrial and Collective Farm Workers								
Intellectuals in the Sciences and Technical Disciplines								
Managers								
Officials in the Commercial and Service Sectors								
"Privileged" Workers with privileges at risk								
Members of Organized Crime								

recentralize as the dilemmas of transition mount. By most estimates, however, a long-run programme and process for change have been put in place. In view of Gorbachev's successes in achieving political reform and his tactical skills, the absence of a plan does not necessarily doom Soviet reform to failure. It may only doom Soviet conservatives and Western analysts to guessing where the implementation of reform will turn next.

Hence, no definite answer can be given to questions about the sustainability of Gorbachev's perestroika. Clearly, he must be able to produce visible results sooner rather than later if the average Soviet citizen is to continue to support reform. The average citizen must be able to enjoy the economic benefits of hard work and individual initiative, and must be given a stake in the system by being able to participate actively in decision-making that affects his everyday life. Indeed, Gorbachev must eventually succeed in raising the citizen's commitment to all aspects of reform in order to implement perestroika fully.

Footnotes

[1]See Proceedings of the Party Conference of June 1988, and Josephine Woll, "The Fruits of Glasnost," *Dissent*, Fall 1988.

[2]This might be likened in a general way to some congressional or parliamentary debates in the West where the leadership clearly sets the agenda and controls the limits of debate in terms of range of issues and timing. Incumbents call this system efficient, the opposition refer to it as authoritarian. In the democratic societies, however, the electorate can and sometimes does both introduce issues and even laws as well as reject undesired legislative outcomes.

[3]Carl Linden has noted that Martin Luther started out with the intention of returning the Catholic Church to its original values and renewing its original purposes but ended up with reformation rather than renewal. It is interesting that Sergei Andreev cites Marx's criticism of the Jesuit character of the bureaucracy in his attack on the Soviet Party nomenklatura.

[4]S. Andreev, "The Power Structure and Problems of Society," NEVA, No. 1, January 1989, pp. 144-173. Chinese reformers in the nineteenth century were said to try to combine Western values in technology and economics (*Yung* or practical use) with Confucian values (*ti* or fundamental structure) but found their ancient philosophy was eroded by modernization; see Donald Gillin's letter to the editor, New York Times, November 14, 1988.

[5]N. Ryzhkov, Annual Report 1988, *Pravda*, January 1989; also "The Soviet Economy in 1988; Gorbachev Changes Course," Report by the Central Intelligence Agency and the Defence Intelligence Agency presented to the Joint Economic Committee of the U.S. Congress, April 14, 1989.

[6]Central Intelligence Agency and the Defence Intelligence Agency, *op. cit.*, p. 2.

[7]See proceedings of the 19th Party Conference June 1988, especially the initial and closing speeches of General Secretary Gorbachev, the speech of L. I. Abalkin, Theses, and resolutions. See also L. I. Abalkin, "Perestroika: puti i problemi," interviews of the Director of the Institute of Economics with Soviet and foreign press from September 1986 to May, 1988 in *Moscow Economika*, May 1988; the June 1987 Plenum decrees, "Basic Provisions for the Radical Restructuring of Economic Management," *Pravda*, June 27, 1987, and Joint Economic Committee of the U.S. Congress, *Gorbachev's Economic Plans*, Two Volumes, Washington, D.C., Government Printing Office, November 1987.

[8]L. I. Abalkin, "Vanquish the Bureaucrat," *Izvestiya*, March 1, 1988, p. 2.

[9]N. Shmelev, "Advances and Debits," *Novy Mir 6*, June 1987, and "New Anxieties,"

Novy Mir 4, April 1988. Shmelev might retain in the short-run the large agricultural units in the South and West, where economies of scale are important, but introduce family responsibilities in sub units of collective farms; family farms would be the norm in central, northern and Baltic regions where large collective farms have been less successful. In February 1989, in a speech at the Kennan Institute, N. Tikhonov predicted that only 30-35 percent of the collective farms will survive the trend toward privatization of agriculture in the next several years. The decisions of the Party Plenum on Agriculture in March 1989 stopped short of offering good land and assured access to supplies and markets that would credibly unleash initiative and hard work by private farmers.

[10] Proceedings of the Congressional Research Service Symposium on "The Swedish Experience: Assuring Industrial Competitiveness in a High-Wage, Full-Employment Economy," Joint Economic Committee, February 25, 1988.

[11] Karl-Eugen Waedekin, *Agriculture in Inter-System Comparison: Communist and Non Communist Cases* (Berlin: Duncker & Humblot, 1985).

[12] Professor Boris Milner of the Economics Institute of the Academy of Sciences of the USSR, in *Arguments and Facts*, reports that a reduction of the "excessively inflated" administrative machinery in the Soviet Union is becoming a reality. Recalling that the country has more than 800 all-union and republican ministries and departments, with nearly 14 million administrative personnel, Milner recognizes that "even for such a vast state as ours these are immense figures. The personnel of the ministries and departments is expected to be reduced by a third on an average. In Moscow alone nearly 100,000 members of the administrative personnel will be relieved of their jobs and be given jobs in other fields of activities." TASS, March 13, 1988. Cf. S. Andreev, "The Power Structure and the Problems of Society," NEVA. No 1, January 1989, pp. 144-173. Andreev is extremely critical of the bureaucracy but pessimistic about prospects for reducing it.

[13] Many of the "reforms" of 1964-1982 had language similar to the decrees of perestroika but lacked effective implementation. Reform proposals from Liberman through Kosygin and "Shchekino" are said to have been frustrated by bureaucratic opposition, especially from ministries such as Finance. Cf. S. Andreev, op. cit. pp. 144-173.

[14] *Pravda*, editorial, April 5, 1988, p. 2; E. Primakov, *Pravda*, March 20, 1988; "Theses" for the 19th All-Union Party Conference, *Pravda*, May 27, 1988; and Resolutions.

[15] Lenin. *Sochineniya*, Vol. 32, pp. 141-247.

[16] Arthur M. Okun, *Equality and Efficiency, The Big Tradeoff* (Washington, D.C.: Brookings, 1975); cf. Edward A. Hewett, *Reforming the Soviet Economy: Equality versus Efficiency* (Washington, D.C.: Brookings, 1988).

[17] In a July 12, 1989 interview with *Izvestiya*, Viktor Pavlov, Soviet Finance Minister, stated that the Soviet state debt stood at 300 billion rubles—roughly one-third of Soviet GNP.

[18] Minister of Finance, Boris Gostev, *Izvestiya*, 31 March 1989. In an article for the April 1988 edition of *Novy Mir*, Shmelev estimated that excess demand, defined as a supply of rubles larger than can be effectively absorbed by available supplies of goods and services, stands at approximately 300 billion rubles, with 100 billion in mattresses, while subsidies supporting unproductive but critical sectors (including about 90 billion rubles of subsidies on meat prices and rent), represent about 25 percent of the state budget. Other official estimates place the overhang at about 100 billion rubles but acknowledge that it is probably larger, although the magnitude is not known: cf. Philip Hanson, "USSR—Inflation Versus Reform," Radio Liberty, Munich, April 6, 1989.

[19] N. Shmelev, "Interconnections between World Markets and Planned Economies," paper presented at the meeting of the International Economic Association, Moscow, March 28-30, 1989. *PlanEcon*, V. 17, April 28, 1989

[20] See the discussion of P. A. Bunich, "Self-Financing of Principal Economic Element:

Prerequisitioning, Essence, Problems, and Trends," *Sotsialisticheskiy Trud*, no. 7, July 1987, pp. 7-17, and no. 9, Sept. 1987, pp. 10-19. Also N. Petrakov, "Prospects for Change in the Systems of Price Formation, Finance, and Credit in the USSR," in *Soviet Economy*, v. 3, July-Sept. 1987, pp. 135-144, and N. Shmelev, Price Reform in the USSR, *Soviet Economy*, v. 6, March 1989. Gregory Grossman argues persuasively that resistance to monetarism is a basis of Soviet conservatism. There is an "iron ring" of vested interests including central managers and party officials that base their power on centralized orders not market signals. They will not only resist monetary discipline but represent a continuing force for recentralization of management.

[21] This seemed to be Gorbachev's point when he stated, "In-depth cooperation and integration must be implemented throughout the *entire cycle, from the field to the counter*. (emphasis added) Second, it is necessary to restructure priority areas of state investments in the agro-industrial complex. At the present stage no longer production itself, but production and social infrastructure must increasingly become the leading target of expenditure." M. S. Gorbachev, Speech to Kolkhoz Congress, March 23, 1988, *Pravda*, March 24, 1988. See also O. Bogomolov, *Kommunist*, No. 16, 1987.

[22] CRS assessment of Gorbachev's UN Speech of December 7, 1988; also F. Burlatskii, *Novoye Misheleniye*, Moscow, Politizdat, 1988.

[23] "Joint Ventures in the Soviet Union: Pace of New Registration Picks Up Dramatically During First Quarter of 1989," *PlanEcon Report*, Vol. V, No. 10-12, March 24, 1989, pp. 1-64.

[24] Pravitelstvennii vestnik, No. 1, January 1989. In this same initial issue of *Government Herald*, V. L. Mal'kevich, chairman of the Committee on Trade and Industry, notes that further effective expansion of joint ventures with the United States would require "wide use of credit facilities."

[25] I. D. Ivanov, *The Soviet Union in a Changing Global Economic Setting: The Prospects for Trade-Oriented Growth*, UNCTAD/ST/TSC/4. Apr. 25, 1986, and "Restructuring the Mechanism of Foreign Economic Relations in the USSR," Soviet Economy, v. 3, July-Sept. 1987, pp. 197-218; see also Norman Scott, "Joint Ventures, Direct Investment, Capital Transfer and Transfer of Know How," Workshop on Ventures, Direct Investment, Capital European Economic Interaction, Session XI: "East-West Economic Relationships up to 2000," May 8-11, 1988, Berlin, GDR, and Marie Lavigne, "International Consequences of the Economic Reformers in Planned Economies," International Economic Association Roundtable, Moscow, March 29, 1989.

[26] However, once a number of joint ventures has been initiated, the "convertibility problem" will crop up again; as large firms begin joint production in the Soviet Union but wish to repatriate profits in dollars, the Soviet Union may face increasing obstacles to the establishment of joint ventures on the scale that they have planned.

[27] Foreign Trade Decree of December 2, 1988. Details on American joint ventures based on Moscow meetings of U.S.-U.S.S.R. Trade and Economic Council, April 12-15, 1988; see also Practicing Law Institute, *Legal and Practical Aspects of Doing Business with the Soviet Union*, New York: July 14-15, 1988, pp. 788; Handbook for meeting chaired by Eugene Theroux of Baker and McKenzie, Washington, D.C.; A. V. Kunitsyin, "Concerning New Thinking on Soviet-American Economic Relations," *Institute of USA and Canada Journal*, December 1988, pp. 3-11; and News Release "American Trade Consortium and Soviet Foreign Economic Consortium Sign Historic Trade Agreement" Moscow, March 30, 1989.

[28] Each American participant is engaged in negotiations on its own projects: Chevron is discussing joint oil exploration and development; Archer Daniels Midland is negotiating joint ventures in agricultural processing, covering areas such as oilseed processing and the production of starch and sweeteners; RJR Nabisco is discussing the production of cookies, crackers, breakfast cereals and cigarettes; Eastman Kodak

expects to set up joint ventures to manufacture and market floppy disks for personal computers and produce blood analysis equipment; Johnson and Johnson is interested in the joint manufacture of any or all of its pharmaceutical, medical, or consumer products.

[29] In the case of the United States, broad expansion of bilateral commercial relations is currently constrained by legal and economic limitations in each country. U.S. commercial policy towards the U.S.S.R. has remained restrictive by global standards. In particular, three U.S. policies strongly constrain bilateral trade: (1) Export and foreign policy controls specifically enumerate goods prohibited for export and place all of the political and economic risks of bilateral trade on private industry. (2) Denial of Most Favoured Nation status and the imposition of specific import restrictions limit Soviet exports to the U.S., which in turn reduces Soviet hard currency earnings and its capacity to purchase U.S. goods. (3) Restrictions on the extension of government credits to the U.S.S.R., based on provisions of the Trade Act of 1974 (P.L. 93-618) and the Export-Import Bank Act (P.L. 93-646) limit Soviet imports and eventually the expansion of joint ventures, particularly given ruble inconvertibility. While Gorbachev's interdependence policy and American competitiveness initiatives may seem to promise closer economic relations between the superpowers, the pattern of the past, small-scale, unbalanced trade, is likely to continue unless there are major qualitative changes in the policy framework (e.g. the signing of a trade agreement) and implementation of Soviet reform.

[30] See Also A. Kunitsyn, "Global Economy: the Choices in Global Economic Strategies." *IMEMO Journal*, no. 1, 1989, pp. 47-56; A. Linden, "Relations of CMEA Countries in GATT," Workshop on East-West European Economic Interaction, Session XI: "East-West Economic Relations up to 2000," May 8-14, 1988, Berlin, GDR; and Committee for East-West Accommodation meeting on GATT, Washington, October 1988.

[31] Jozef M. van Brabant, *The GATT and the Soviet Union—A Plea for Reform*, Working Paper No. 6. Department of International Economic and Soviet Affairs, United Nations, August 1987.

[32] Discussion by Soviet authorities regarding the improvement and wide release of statistics may lead to more transparency in important economic measures. Academician Abel Aganbegian has publicly noted that by 1991 all macroeconomic statistics (including information on gold stocks and all national accounting data) will be prepared and published according to standards consistent with United Nations policies.

[33] John Hardt and Timothy Stanley, "Economic Indicators in Soviet Security Policy," Atlantic Council, April 1989.

[34] Thomas A. Wolf, "Market-Oriented Reform of Foreign Trade in Planned Economies," Moscow Roundtable on "Market Forces in Planned Economies," March 28-30, 1989.

[35] T. Zaslavskaya, "Concerning a Strategy of Social Guidance of Perestroika," in Y. Afansaiev, editor, *Perestroika: Glasnost, Democracy and Socialism, No Other Way*, Moscow, Progress Press, 1988.

[36] For very perceptive assessments, see Abraham Brumberg, "The Struggle Inside Moscow," *New York Review of Books*, March 30, 1989, pp. 37-42; also Elizabeth Teague with comments by Peter Hauslohner, "Perestroika: Who Stands to Gain, Who Stands to Lose?" presented at the Institute of Defence Analysis, Alexandria, Virginia, March 9, 1989.

Commentary by Oleg Bogomolov

The main conclusion drawn by John P. Hardt and Sheila N. Heslin in their very pithy and comprehensive analysis of Soviet perestroika is reflected in the very title of their paper—"Perestroika: A Sustainable Process for Change". Though I second the implied conclusion, I would formulate it slightly differently: the major success of perestroika is that it is still continuing. Its irreversibility has not yet become evident and irrefutable.

The essence of perestroika is captured quite accurately in the paper, and the various interrelated aspects of perestroika are considered in proper succession. The logic of the analysis is irreproachable. It is very difficult for an outsider to understand the anatomy of such a complicated and contradictory process as perestroika and renewal in the USSR. Yet Hardt and Heslin manage to do this in the main. Their paper gives not only a proper description of the changes ongoing in the USSR, but makes a credible attempt to assess the balance and interplay of various public forces backing these changes.

The authors do not forecast perestroika's success or failure but instead outline the factors that may influence the attainment of the new future conceptualized by perestroika. For example, they write, "No definite answer can be given to questions about the sustainability of Gorbachev's perestroika." At the same time, they suggest the possibility of a still not-yet-strong bottom-up support for perestroika which, "combined with Gorbachev's evident skills as a political tactician at the centre of power" may decisively influence the pace, sustainability and success of perestroika. They highlight the tensions in the process, concluding from

their "calculus of success" that continuing change is probable.

My view of perestroika "from the inside" is, of course, somewhat different from the authors' perceptions "from the outside," but these differ in details and nuances. It is difficult to argue with authors whose analysis seems to be rather objective and whose conclusions are quite convincing. That is why my comments should not be regarded as criticism but rather a supplement to their analysis.

Our feeling is that perestroika has turned out to be a more difficult and attenuated process than was expected by the population at the beginning. Specific results in different areas cannot be assessed separately or unambiguously. I agree with the authors that "tangible economic benefits have been minimal." Indeed, in 1988, the situation on the consumer market noticeably deteriorated. But the feeling in the country is that the process of change is progressing, becoming stronger.

If the situation in the USSR is regarded in the context of the shifts occurring in China, Hungary, Poland and some other socialist countries, one can come to the conclusion that the search is ongoing for a new model of socialist societal organization adequate to the modern epoch with its revolutionary changes in technology, culture and information, the need for democratization of public life and international relations, and for new political thinking. The Stalinist model proved to have no prospects for ensuring social progress under the changed conditions. Nevertheless, the new model still does not enjoy a consensus of opinions. It creates what Hardt calls "an identity problem" for socialism. The actual experience of individual countries in the renewal of socialism is ambiguous. But it is clear that the changes already under way will have far-reaching domestic and international consequences. The image of socialism will be radically changed.

Hardt and Heslin interpret "renewal" as returning to the original values of marxism, a "return to the proper Leninist course" and as a reassessment of our own history, taking lessons from such tragedies as mass murders under Stalin, forced collectivization, etc. By the term "renewal" they also understand the development of an indigenous model of perestroika responsive to historical traditions and specific circumstances of the Soviet Union.

As understood by Soviet scholars, the term "renewal" acquires a broader sense: revision or denial of some Marxist doctrines rejected by practice, imparting to socialism a humane image so that a free and all-round development of each individual becomes a precondition for the

progress of the entire society; development of natural mechanisms of self-regulation in public life (democracy, market); recognition of pluralistic forms of ownership and political interests, with the leading role of public ownership being preserved; delegation of the entire power to the people; distributional relations ruling out acquisition of other people's labour and exploitation; ensuring prosperity of the economy and its planned crisis-free development; and imparting an open character to the society and economy. In fact, the Soviet interpretation of "renewal" erases many demarkation lines between socialism and capitalism, makes it possible to take a new look at the theory of convergence, and sets the task of identifying socialism in its new quality. The alienation of the two systems seems to be in the process of being bridged step by step.

Perestroika in the USSR has been under way for four years. Changes have occurred in political concepts, including foreign policy, in the mass media, public consciousness, and culture, in legislation, and in cadre policy. The political climate in the country is being improved. Economic practice has been influenced by these political changes. The task of democratizing the society and the party has been put on the agenda, and an acute struggle for its practical realization is going on. Up to now, however, this is more liberalization than democratization of society in the fullest sense. The most radical shifts have taken place, perhaps, in the public consciousness, in understanding by the society of its past and of those problems that still have to be resolved, the least in the economy.

Overall, perestroika is supported by the majority of the population, since they understand that there is no other alternative to stagnation and sinking further into a deep social and economic crisis. The Soviet people are full of expectations, with active interest in the press and TV-broadcasting, but no real improvement in their life has come yet. As one of our humorists says, today it is more interesting to read than to live.

The produced national income increased in 1988 by 4.4 percent, versus 3.2 percent on average over the two last years. The results of 1988 point to acceleration in the rate of economic growth, but due to aggravation of inflation trends and growing difficulties in supply and in external economic relations, this positive result is not yet evident to the population. Moreover, the national income actually used for accumulation and consumption is less than what was produced, since losses took place, including those from the worsening terms of external trade. The situation, however, is being improved in agriculture and housing. Over 1986-1987, the gross agricultural output increased by 18 percent, as compared to the

average annual level of the preceding five-year period; the grain yield gain was about 30 million tons and that of meat about 2.1 million tons. However, these results are insufficient and did not eliminate the necessity for large-scale import of grain and other foodstuffs. Over the last three years, imports cost nearly $50 billion (30 billion rubles). Furthermore, 1988 was a year of crop failure and, evidently, it will provide only a very modest gain in agricultural output, with an actual decline in the grain yield (to 195 million tons). State budget funds are being rearranged to satisfy the urgent social needs of the population, with special emphasis on health care, education, and housing. The number of new apartments increased from 2.1 million units in 1986 to 2.3 million in 1987 and about the same number in 1988. Wages of teachers and medical personnel are being increased. In addition, a pension reform is being introduced which, it is expected, will result in higher pensions.

The reform of the Soviet economy is burdened with problems which accumulated during previous decades of stagnation. First, the lag in the development of agriculture and in the manufacture of consumer goods, in combination with the over-development of heavy industry, is one of the fundamental defects of our economy. Moreover, heavy industry itself developed irrationally. One result is that machine-building, chemistry, and electronics are still underdeveloped. The production infrastructure is another weak point. Building capabilities are keyed to the construction of new projects and are poorly adapted to jobs associated with modernization and re-equipment. Among such problems the most serious implications are associated with significant disturbances in the structure of social production; the low quality and technical level of many products; high production costs; insufficient skills; and the culture and discipline of workers.

Furthermore, the structure of the economy retards rapid changes and renders the economy inflexible in the face of a rapidly changing environment. To a great extent, this explains the fact that the leadership's expectations for the development of a modernized, competitive economy have not yet come about. Another factor which retards Soviet economic development is the inertia of the existing mechanism of economic management, reinforced by bureaucratic resistance. Indeed, this explains why the economic independence of enterprises and their transition to self-financing can be ensured only partially, though they are required by the law on the state enterprise that went into effect in 1988.

The reasons for this lack of transition are the continued strict control

on the part of ministries, the lack of a wholesale-trade market, and the imperfection in price and tax systems. The situation can be improved through a price reform and replacement of the state system of distribution with wholesale trade. This will take several years.

Market methods of economic management still do not play their proper role and, therefore, have not provided tangible results in reducing production costs, increasing the productivity of labour, improving the quality of goods, or accelerating technological progress. The planned regulation of production is effected through compulsory state orders. In 1988, state orders covered 85 to 100 percent of industrial output. In the current year, it will be applied to little over 25 percent of machine-building output, just 60 percent of the products of the fuel and raw-material industries, and over 30 percent of light industry output. The output not covered by state orders is intended to be commercialized through wholesale trade at prices which to a greater extent will be set on the basis of contracts between sellers and buyers.

In the future, state planning will become increasingly indicative in character. We intended to stop making centralized annual plans and to limit the planning function to making five-year plans only. Likewise, state influence on the economy regarding the realization of planned targets will become indicative. Specifically, state direction will be implemented in several ways:

- through the allocation of financial and material resources still remaining at the state's disposal (their share will be considerably reduced);
- through taxation, credit, and price policies;
- through the remaining state orders.

The success of perestroika is determined today to a great extent by the success of therapy for two harmful diseases: inflation, and the shadow economy which nourishes corruption. The state budget has suffered from a deficit for a long time. This year, it is expected to amount to 100 billion rubles or 11 percent of the gross domestic product (GDP). The budget deficit is a direct consequence of a rapid growth of expenditures and a considerable reduction of budget revenues. In particular, the drop in the latter may be attributed to the sharp decline of prices of Soviet exports and to cuts in the state production of alcohol. The budget deficit is being covered by issues of money and credit not backed by goods. And the state debt is growing. In other words, the money in circulation exceeds the value of commodities available to absorb the purchasing power. Despite state controls, retail prices have risen by 4-5 percent a year. And growing

inflation has led increasingly to the disappearance of one commodity after another from the consumer market: TV-sets, refrigerators, soap, electric lamps, etc., have become items in short supply.

Similar difficulties are experienced by industrial and agricultural enterprises in acquiring with their own money, construction materials, metal, transport and building machinery, and many kinds of equipment. And this "hunger" for commodities has become more acute, despite an increasing output of "deficit" goods.

The recovery of the money-credit system and, hence, of the domestic market (both the consumer market and the wholesale market being newly created) is intended to be accomplished by cutting budget expenditures (military ones, spending on some major investment projects, subsidies to losing enterprises, and management expenses), by sales and leasing of some kinds of state property (small- and medium-scale enterprises, flats, and land plots), by stricter control of the growth of cash payments to the population, and by growth of tax revenues through higher efficiency and gains in the productivity of enterprises. But the main priorities set are for higher outputs of foodstuffs and manufactured goods for the population.

The progress of perestroika involves adjustment in its original concept, change of priorities in economic policy. The general course remains unchanged: rejection of command-administrative methods of management and incorporation of market mechanisms into the planned economy. There is a greater understanding of the fact that perestroika can provide the quickest results in agriculture and in industries producing goods and services for the population and that these are the sectors in which the appropriate measures should be taken first. This draws on the experience of Hungary and China.

In agriculture, the task is to liberate the producer from administrative intervention and control on the part of the party and state authorities. To shift over to market forces of management, the principles of independence and self-financing by collective and family farms are in the process of being implemented. In addition, collective and state farms are to be transformed into non-state cooperatives. Increased emphasis is to be put on the leasing of land, equipment, livestock, and other property to family collectives or small cooperatives. The lease-holding contract can provide an increase in gross output and in labour productivity ranging between 50 and 100 percent, as numerous examples show.

The enhancement of market regulation in agriculture in 1988 resulted in reducing by one-third the unfulfilled demand for agricultural

machinery, especially tractors and grain harvesters. The recent meeting of the CPSU Central Committee dealing with agrarian matters should become a landmark in the emancipation of agriculture from administrative- bureaucratic control and in the transition to new forms of agrarian relations. The law on lease-holding has been prepared. Steps are being taken to shape a market for agricultural production and to abandon gradually the administrative system of distribution.

The new legal right to lease authorizes collectives to lease industrial enterprises. Several dozens of small enterprises have already been leased by the state under the new law, and many unprofitable enterprises have quickly become more efficient and profitable.

The law on cooperatives gave rise to a strong cooperative movement in towns. About one hundred thousand cooperatives have been formed in construction, services, the manufacture of consumer goods, and other spheres. They satisfy numerous needs of the people, although their total sales do not exceed one percent of the retail turnover of the country. Because of imperfections in their legal and tax regulation and the absence of clear fiscal control, the activities of cooperatives have engendered strong resistance from the citizenry. The state has refused to provide cooperatives with many kinds of raw materials, components, and machinery badly needed by them at state prices. In the absence of wholesale markets, cooperatives were bound to resort to illegal sources of supply through bribes. Enjoying almost unlimited freedom to set their own prices, they passed on their expenses to the consumer. State enterprises without this flexibility were unable to compete and bring their prices to levels competitive with the cooperatives. The unsatisfied demand of the population for numerous goods and services enables cooperatives to inflate prices and incomes, frequently without any concern about the quality of their products. Up to now, unfortunately, cooperatives have given an additional impetus to inflation and corruption and enhanced an unearned differentiation in incomes. Under the pressure of public opinion, efforts are being taken to restrict and, in some cases, even prohibit cooperative activity.

In the series of measures for improving the Soviet economy, special emphasis has been given to the expansion and radical re-equipment of the light and food industries, as well as the rapid building-up of capacity in the manufacture of cars and other durable goods. In past allocation of investments and foreign-exchange funds by the state, the interests of the light and food industries were usually neglected. As a result, their

equipment has been outdated for decades. Now an accelerated modernization is planned, along with the erection of new plants, especially small- and medium-sized ones. The state assigns large investments for these purposes, intending, for example, to double the capacity of light industry within 6-7 years. More than one hundred enterprises and R&D teams of the military sector have been engaged in the design and manufacture of equipment for these industries.

All of the productive assets of the economy need renovation on a modern technological basis. Perestroika through technological restructuring has as its most important component solution of the problems of applying scientific and technological progress to the production process. Still, we have only limited opportunities for increasing investment in technical reconstruction. Soviet resources are very scarce, requiring us to give priority to the modernization of existing plant and equipment with a view to ensuring a rapid recoupment of investment. For similar reasons, a greater number of small-scale projects are being implemented, and the scope of capital construction is being narrowed. The construction sector itself is undergoing perestroika and rearrangement so as to improve its efficiency and reduce both time limits and costs of construction.

Insofar as investment resources are available, machine-building ranks first in the programme of modernization of the national economy, since it defines technological progress. The forms of integration of science and production are being improved. There are intentions to establish research-and-production concerns which would incorporate the enterprises of different ministries. A strong need for that is felt in the new areas of technology.

It has become especially urgent to reform economic relations between the central and local powers, aiming at a greater independence for indigenous bodies of management in the republics, territories and regions. The principle of equivalence should be more strictly observed in interregional exchange. And the shares of individual territories in covering federal spending should be defined on the basis of more definite and just criteria. The budget of a region and supply of the regional market should be put into a proportional relationship to the contributions of local economic activities.

The main reserves for improving the economic situation, which perestroika should unleash in the short run, are domestic and mainly in the political sphere, rather than in the economic sphere. Democratization

of society, emancipation of the people's consciousness, awakening of talents, and a moral uplifting of society are capable of giving a strong impetus to further development.

The elections were an important event in the course of perestroika, the influence of which on its future can be very significant. They have demonstrated a high level of a political activity in broad strata of the population and the development of Soviet civic self-consciousness. Despite the fact that perestroika has not yet resulted in an improvement of the material well-being of the population (it even decreased), faith in perestroika is not lost. The majority of the people not only still support perestroika, but also vote for its realization by way of radical, not halfway measures.

The elections have brought to the forefront a great number of new brilliant public figures with independent thinking and constructive programmes for a further intensification of the process of perestroika. At the same time, they have revealed the crisis of voters' confidence in the party apparatus, whose numerous representatives failed to get elected. The apparatus is disturbed by the development of democratization and glasnost. The CPSU Plenary Meeting of April 1989 resulted in the retirement of about 110 members of the Central Committee and partly replaced them with protagonists of the reforms. This has strengthened Gorbachev's position.

But the Congress of People's Deputies convened on May 25, 1989 is becoming the arena for a new trial of strength. It might contribute to departures from the policy of balancing between radicals and conservatives and to the adoption of a more resolute course for carrying out economic and political reforms capable of helping the country out of its current economic crisis.

The political reform is closely linked with the new electoral process, resolving another key problem of perestroika—the need to elevate competent and professional figures to positions of power. This still remains a serious obstacle in the way of transforming public life and improving the efficiency of the Soviet economy. This problem, unfortunately, has fallen beyond the scope of the authors' paper. Yet the training of Soviet managers and selection of the most competent specialists for promotion to the leading posts is regarded generally as one of the main preconditions for the success of the reforms.

The aims of perestroika also include the activation of trade and cooperation with other countries. Despite the measures taken recently to

make the Soviet economy more open to the external world, real shifts for the better will take time. Foreign trade turnover is still stagnating, mainly due to the drop in oil prices. This unfavourable trend should, of course, be counteracted.

The Soviet Union and East European countries have lost or are losing to a substantial extent their former specialization in world trade, but have not yet acquired a new one matching their potentialities and the requirements of the scientific and technological revolution. It is not the West that eats Russian bread, but the Soviet Union is still bound to buy from the West nearly one-quarter of the wheat it requires. Our raw material resources have also been considerably devalued, especially after the West overcame the energy crisis. Gold has lost its role as the "currency of currencies" and has become a mere commodity. As regards the huge Soviet manufacturing sector, it remains substantially non-competitive on world markets. In those few areas where the USSR and other European socialist countries can offer intermediate or final goods of good quality and price, their export capacities are relatively small.

In short, today the East is obviously more interested in business cooperation with the West than vice versa. This fact should be added to the uncertainties surrounding the rather dramatic changes ongoing in many socialist countries—processes that increase commercial risks because of the instability of the situation and the indefinite character of the progress of further events. Western countries, of course, understand what potential resources (material and intellectual) are available in the Soviet Union and other East European countries and what vast markets they might have. To realize the potential opportunities for expanding both exports and imports, however, these countries have to wait out the long and difficult process of perestroika. It is obvious that Western governments have not yet made the final choice as to the manner and scale of economic assistance to perestroika in the Soviet Union or to its involvement in world economic relations. This might be explained by the fact that economic arguments have not acquired the appropriate weight in such policymaking.

As regards the Soviet Union and many other socialist countries, the orientation of their governments to the expansion of business relations with the West unquestionably becomes stronger. One may even say that a qualitatively new situation is being formed here. Whereas the Stalinist model for constructing a socialist society assumed substantial isolation from world economic relations, new thinking rejects the faith in this dogma established over decades. No longer are foreign economic relations

rejected because it is impossible to subject such relationships to a plan, or because of a potential threat of dependence on a hostile capitalist world. Instead, new thinking rests on the concept of the interdependence of the world and of its individual regions, and the necessity of taking this into consideration in foreign policy. It embraces broad economic interdependence, retaining technology and economic independence only in vitally important areas. This means an orientation based on a greater openness of Soviet society and its economy to the outside world, as well as active involvement in the global division of labour and in the system of world economic relations. The new political thinking assumes that the interests of the participants will be balanced, with due account for the particular expectations and specific interests of each partner in world economic relations.

These changes in the general foreign-policy concepts of the governments of many socialist countries are followed by practical steps. For example, the Soviet Union has declared its desire to take part, together with all countries and in various international forums, in discussion and solution of global economic problems and matters pertaining to the regulation of the world economy. Following the same objectives, it has also put forward the principle of ensuring economic security of states (i.e., the creation of a world economic order under which each state would abstain from actions directed explicitly against the economic interests of other states). This principle necessitates consideration of objective needs and trends in world economic development leading to a gradual consolidation of countries, not their confrontation with one another, making harmonization of their interests indispensible.

The de-ideologization of interstate relations offered by the Soviet Union follows the same course. In other words, ideological differences should not affect interstate relations. This does not at all mean neglecting social and ideological differences, but necessitates, even in their presence, a peaceful co-existence, competition and interaction within the framework of a pluralistic, interrelated world community. De-ideologization does suggest respect for the freedom of each nation to choose its own political system and its own system of ideals.

The problems that used to face countries individually have acquired a global character due to the scientific and technological revolution and the resulting acceleration in the internationalization of economic life. The maximum utilization of the enormous potentials of modern science to the benefit of all countries and maintenance of the normal development of the

world economy have acquired great importance among global problems, including prevention of thermonuclear war and of ecological catastrophe, ensuring better use of world resources of energy and raw materials, and fighting starvation and dangerous diseases. The solution of these global problems should become one of the main goals of all governments, since it is necessary to organize here broad international economic, scientific, and technological cooperation based on the solidarity of the whole of mankind, not of narrow selfish interests or a struggle for elimination of competitors.

In this connection, the policy of regional integration also needs a certain reevaluation. Its positive effect is proven by the experience of both CMEA and EEC. However, it is impossible to close one's eyes to the contradictions between integration on a regional basis and the globalization of economic life. Overcoming this contradiction involves a combination of both aspects of foreign policy in the activity of governments. Taking into account existing realities, formal relations between the CMEA and EEC have been established, and individual countries of the CMEA have signed agreements with the EEC.

Governments of CMEA countries do not deny the advantages of integration and cooperation within the CMEA framework and assign, in principle, priority to it. But facing new organizational and structural difficulties in the way of expanding their mutual trade, they start to rearrange their activities to a growing extent towards world economic relations so as to make better use of the opportunities and advantages of both regional and global cooperation.

Being fully aware of the importance of further progress of the unique Helsinki process and the necessity of intensifying all-European cooperation, the USSR and other East European countries supported the idea of establishing a "common European home" and now strive to fill it with real contents. They have already suggested specific measures in the military and political spheres, as well as in economic, ecological and cultural areas. It is intended gradually to shape an appropriate infrastructure which would help overcome the division of Europe and build a common European home from the Atlantic to the Urals. It should be noted that European cooperation is far from being regarded as a counterweight with respect to interactions with other countries and regions.

The Soviet Union has undertaken the task of enhancing its economic and political significance in the vast Asian-Pacific Region [APR] to which the centre of gravity of the world economy and policy is gradually being

shifted. The USSR has proposed a programme for the development of broad mutually beneficial cooperation (multilateral and bilateral) which would meet the interests of all countries of the APR. The Soviet Government has undertaken measures to involve the resource-rich Soviet Far East in trade, production, and scientific and technological cooperation with China, Japan, the newly industrialized states of the APR, the USA, and the ASEAN countries.

Taking into consideration the growing significance of international organizations in the development and regulation of world economic relations, the Soviet government came to perceive the necessity of promoting their authority, improving their efficiency and taking a more active role participating in them. This pertains not only to the UN and its special and regional institutions, but to other international organizations as well. The USSR, for example, has declared its readiness to join the GATT and interact with other international economic organizations and financial institutions to facilitate their constructive activities in all directions, including East-West cooperation.

Unfortunately, Western countries have not yet given up the strategy which more closely resembles the restriction than the facilitation of Soviet participation in global economic processes and in international economic organizations. Opinions are still encountered according to which this participation can be detrimental to U.S. interests, by enfeebling the system (created by them during the post-war period) based on the economic and political attachment of Western Europe and Japan to the United States.

From the perspective of solving global problems and improving East-West relations, the domestic policies of the USSR and other countries of Eastern Europe should be newly analysed. Until recently, they fenced these countries off. Now perestroika gradually removes numerous internal obstacles limiting the openness of the economy and allows increased interaction between domestic and world markets.

In the USSR, a radical reform of external economic activity is ongoing. Twenty two thousand state and cooperative enterprises have obtained the right of access to world markets (directly or through economically responsible intermediaries). Their economic interest in the efficiency of external economic operations has therefore been increased, and more so through the self-financing and credit arrangements which were introduced along with opportunities for them to exchange foreign currency on the basis of auctions.

Soviet reformers have realized that the export potential of Soviet

industry and science should be enhanced. So far, the export potential has not been utilized fully because of bureaucratic centralization of management and insufficient information about its achievements in other countries. After April 1, 1989, Soviet export capacity was apparently improved, since all enterprises, associations, and production cooperatives were to start to exercise their right to engage in direct export-import transactions. An important basis for expanding Soviet exports is the vast stock of scientific and technological achievements accumulated by the Soviet Union in basic and applied research. Its commercial use would make it possible to export many additional products. This is one promising area for joint ventures with Western companies.

The use of credit to expand imports of machinery and equipment from the West cannot be regarded as a promising way to promote external relations. Today the cost of these foreign credits is very high. Taking into consideration inefficiencies in starting up imported equipment and in ensuring its profitable operation (which, unfortunately, are characteristic for us), the growth of foreign indebtedness will lay a heavy burden on the Soviet economy. Therefore, it is likely that preference will be given to other forms of collaboration: industrial cooperation, joint ventures, and special economic zones to encourage the establishment of joint ventures on Soviet territory.

Several scores of joint ventures with Western companies have been formed. The economic, financial, and legal conditions of their establishment and functioning are consistently being improved. The Western approach to investments of this kind had been rather cautious. In particular, the requirement that profits be repatriated in foreign exchange has seriously restrained progress in expanding this form of business relationship. Certain conflicts of interest may be observed, since Western firms intend to expand their sales on the Soviet market, while we want to increase our income in convertible currency by means of such joint ventures. Difficulties also include insufficient information about the available possibilities for organizing joint ventures and about demands for certain products. Moreover, the activities of joint ventures are hindered by the lack of a free market for raw materials, difficulties in ensuring a trouble-free supply of components, parts, and materials. Still, the greater difficulty resides in the poor adaptability of the internal economic mechanism of the USSR to incorporation of joint ventures in it, as well as the inconvertibility of the Soviet ruble in combination with an unrealistic exchange rate.

Evidently, the obstacles in the way of the formation and functioning of

such enterprises can be overcome to a great extent through the provision of special tax-free economic zones which would have a preferential legal and economic regime. The enterprises operating in these zones would be given the opportunity to carry out their transactions in convertible currencies and at Western market prices (except for wages, land rents, etc.); this might eliminate the problem of the poor adaptability of their operational activity to the internal economic mechanism. The possibilities for the creation of such zones on the Baltic and Black Sea coast, at the Soviet-Finnish frontier, and in the Far East, as well as the mechanism for their functioning and self-management are being studied now by the Soviet government.

In the assessment of the prospects for a greater involvement of the Soviet Union in the world economy one more significant circumstance should be taken into consideration. An important role in the integration process occurring in the world economy is played by multinational or transnational corporations. Despite all the controversies about their activity, viewed from the perspective of the national interests of the countries where they have their affiliates, these corporations do contribute to the spread of technological progress and the enhanced interdependence of different countries. They have an ever growing influence on the dynamism and geographic flows of world trade. The Soviet Union has no large transnational companies with affiliates in various countries of the world, nor has it affiliates of Western transnational corporations on its territory. Joint ventures will evidently contribute to the transnationalization of production in the Soviet Union as well. But at what time and in what forms it will take place is difficult to foresee now.

An impulse for the revival of the world economy and expansion of world trade, including that between East and West, could be generated, in my opinion, by the practical implementation of the proposals for the control and reduction of nuclear and conventional arms. Only limited progress in this area is observed now. Nevertheless, the conversion of Soviet military industry to civilian manufacturing is increasingly becoming a practical task. In the West, it is associated with the search for new markets; in the East, with expansion of import opportunities. Through cuts in its enormous counter- productive military spending, the USSR will become an even more promising partner for Western companies. It is evident that finding the balance of interests in the political sphere for settling actual political controversies becomes today the main factor for activation of business cooperation. Its expansion, in turn, can promote

interest in a political detente as well.

The trends in the development of world trade during recent decades are characterized by intensification of exchanges within each of the three worlds: North- North, South-South, East-East. To some extent, this is an objective of the external economic policy of developing and socialist states. For this reason, it is quite possible that the socialist countries will give priority in the future to the development of mutual economic relations. The inclination of the CMEA member countries towards a substantial intensification of their integration is well known, especially in solving major scientific and technological problems, and in advancing industrial cooperation. It is in fields of modern technology that the CMEA member countries are endeavoring to ensure their independence and invulnerability on the basis of mutual cooperation, for guarding against CoCom's embargoes. But the general motto of their external economic strategy can be formulated as intensification of their mutual cooperation in the interest of strengthening competitive positions in relations with the rest of the world, first of all with the leading industrialized countries.

Once again, the main reserves for improving the economic situation of the USSR which should be unleased by perestroika are, of course, domestic and primarily in the political sphere. Democratization of society, emancipation of the people's consciousness, awakening of talents, and a moral uplifting of society are capable of giving a strong impetus to further development. The hopes for acceleration of social and economic progress are also associated with imparting a more open character to our society and economy in respect of the rest of the world.

The turning points experienced to date by the Soviet Union in its internal development and its external economic relations makes us consider the course of events in the future. The changes observed in politics and in mechanisms of societal organization, though in the initial stage not widespread, point to future improvement. This process will apparently take 10 to 15 years and will be accompanied by an acute debate, reflecting conflicts between the old and new modes of action. As regards relations between different social systems, the resolution of many contradictions can be expected, as well as a greater compatibility of economic interests and approaches. East-West interaction will be a process of strengthening interdependence and thereby the economic development of the countries of the world.

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